



AIMA AUSTRALIA

SUBMISSION TO THE AUSTRALIAN SECURITIES & INVESTMENTS COMMISSION

**CONSULTATION PAPER 147 HEDGE FUNDS: IMPROVING DISCLOSURE FOR
RETAIL INVESTORS**

28 APRIL 2011

**A submission prepared by the Regulatory Committee
of the Alternative Investment Management Association
Australia Chapter**

AIMA AUSTRALIA
SUBMISSION TO THE AUSTRALIAN SECURITIES & INVESTMENTS COMMISSION
CONSULTATION PAPER 147 HEDGE FUNDS: IMPROVING DISCLOSURE FOR
RETAIL INVESTORS

Background on AIMA Australia

The Alternative Investment Management Association (**AIMA**) was established in 1990 as a direct result of the growing importance of alternative investments in global investment management. It is a not-for-profit educational and research body that specifically represents practitioners in hedge funds, futures funds and currency fund management - whether managing money or providing a service such as prime brokerage, administration, legal or accounting advice. AIMA's global membership is in excess of 1200 corporate members, comprising 5000+ individuals in 46 countries.

The Australia network of AIMA Australia (**AIMA Australia**) represents participants in alternative investments in Australia. AIMA Australia has over 60 members, including fund of funds managers, institutional investors, hedge fund managers, prime brokers, lawyers, auditors and other service providers.

1. Summary:

- Generally AIMA and its members agree with the disclosure principles and the benchmarks that are set out in the "Consultation Paper 147 - Hedge Funds: Improving Disclosure for Retail Investors" (**CP 147**).
- However, AIMA does not support limiting the enhanced disclosure guidelines to 'hedge funds', for the following reasons:
 - The features of a 'higher risk' fund listed in Proposal B2 are common to many other types of managed investment schemes. Accordingly, consistent with Australia's principles-based regulatory regime, it is more appropriate that the principles and enhanced disclosure benchmarks apply to all complex products, including hedge funds, that have these features.
 - The definition of hedge funds as proposed will give rise to uncertainty, regulatory arbitrage and exclude many high risk schemes that should not be excluded. (See paragraph 2.)
 - Finally, AIMA supports all complex funds (including hedge funds) being excluded from the shorter PDS regime. To avoid unnecessary compliance costs, it requests that ASIC clarify its position on this as soon as possible.

2. Proposal B: Scope of ASIC's proposed guidance

Proposal B1: Focus should not be limited to "hedge funds"

AIMA submits that the principles and benchmarks for the enhanced disclosures should apply to all *complex products*, including hedge funds and fund of hedge funds, for the following reasons:

- There is no generally accepted definition of hedge funds, either in Australia or internationally. It is therefore appropriate to apply a principles-based approach to determining which products should be subject to enhanced disclosure, rather than on what a fund is called.
- A focus on "hedge funds" (however that may be defined) could result in the other funds with diverse investment strategies avoiding compliance with the enhanced disclosure regime. From Section A of CP 147 it is clear that ASIC is seeking to protect investors from funds which "pose more diverse and complex risks for investors than traditional managed investment schemes". In AIMA's view these risks are not limited to hedge funds.
- The emphasis in Proposal B1¹ is on the nomenclature of "hedge funds" and AIMA submits that this presents an opportunity for regulatory arbitrage. By way of example, there may be circumstances where a fund's operator, investment manager or promoter do not consider the fund to be a "hedge fund" or a "fund of hedge fund" but it is "generally regarded as a hedge fund or a fund of hedge funds", leading to uncertainty about whether the enhanced disclosure regime or (if ASIC agrees with AIMA's submission that complex products should be exempted) the shorter PDS regime should apply. An undue focus on nomenclature could result in two very similar funds, one called a hedge fund and one called an actively managed or benchmark unaware fund, complying with different disclosure requirements. In those circumstances an unsophisticated investor may invest in a fund which complies with the shorter PDS regime on the mistaken assumption that such a fund is less risky when in fact it is quite likely that the reverse could be the case.

AIMA supports a more substance based approach in considering whether the enhanced disclosure principles should apply to a particular fund. AIMA and its members consider the factors listed in Proposal B2 should be taken into account and it should not matter whether the fund is or is not labelled as a hedge fund by the issuer or any third party. However, ASIC should not articulate the weighting that should be placed on each of the factors as different complex funds will possess different factors and in different weightings.

Proposal B3: Wholesale Funds and Listed Investment Companies

AIMA agrees with Proposal B3 that the proposed disclosure principles and benchmarks be encouraged as best practice for offers to wholesale investors and offers by listed investment companies of complex products. However, these principles and benchmarks should not be prescriptions for wholesale offerings.

Proposal B4: Interaction with the shorter PDS regime

AIMA supports the proposal to exclude hedge funds from the shorter PDS regime and submits that this exclusion should equally apply to other complex products.

A large number of funds – particularly daily priced funds – will have sufficient liquidity to fall within the requirements of the shorter PDS regime. However, given the complexity of these funds, their structure, their underlying investment strategies and the requirement to comply with the enhanced disclosure regime contemplated

¹ Proposal B1 introduces a subjective test about whether the vehicle "is, or has been promoted as, or is generally regarded as a hedge fund or a fund of hedge funds".

by CP 147, it will be difficult for them (and other issuers of complex products) to provide adequate disclosure in 8 pages.

AIMA urges ASIC to confirm its position regarding whether hedge funds (and other complex products) are excluded from the definition of 'simple managed investment schemes' (detailed in Proposal B4) as soon as possible. The shorter PDS regime is scheduled to commence from 22 June 2011 for new funds. If this commencement date is not deferred, issuers of new hedge funds which meet the liquidity test will have no option but to prepare a short form PDS from 22 June 2011. They will then face significant additional costs if they are later excluded from the short form PDS regime and required to comply with the additional disclosures from 1 July 2012. There will be significant compliance costs and large uncertainty for product issuers during this period.

3. **Proposal C: Disclosure principles and benchmarks**

AIMA agrees with enhancing disclosure for offers of complex products to retail investors. In relation to the individual principles and benchmarks:

- **Proposal C2: Investment Strategy**
 - AIMA supports the proposal to include more information on the investment strategy, including information on the proposed asset classes, role of leverage, derivatives and short selling.
 - While AIMA acknowledges the importance of risk management, it is not clear that setting out the risk management strategy in the PDS will be helpful for retail investors given the degree of complexity these strategies can entail. Risk management strategies are currently covered in the compliance plan and audited by the compliance plan auditor.
- **Proposal C3: Investment Manager**
 - AIMA supports in principle the proposed disclosure of information on senior investment officers or key investment personnel and their previous experience, subject to the following:
 - It is to be expected that senior decision-making officers will change from time to time and that at larger funds this may happen more often than at smaller funds. In the circumstances it would be onerous for a new PDS or supplementary PDS to be prepared. AIMA submits that it would be appropriate for such changes to be disclosed on the fund's website.
 - AIMA submits that there is merit in extending this disclosure requirement to funds other than issuers of complex products, given that reliance on senior members of investment teams is equally applicable to other types of funds.

- **Proposal C4: Fund Structure**
 - **C4(a) - Investment Structure.** Investors should be provided with adequate information to make an informed decision before investing. It is common for Australian registered managed investment schemes to invest through intervening structures (eg, master/feeder fund structures) and AIMA agrees that such structures and the jurisdiction of intervening investment vehicles should be disclosed. AIMA submits, however, that it is neither necessary nor useful for retail investors to be informed of the reason for choosing a particular jurisdiction.
 - **C4(b) - key service providers.** AIMA agrees that the Australian fund should disclose the key service providers to the fund in the PDS.
 - **C4(g).** Proposal C4(g) proposes the requirement to include the details of the key service providers of an underlying fund if more than 10% of the Australian fund's net asset value is invested in that underlying fund. AIMA and its members have two submissions on this proposal:
 - The 10% threshold level is too low. As fund of funds typically hold positions in underlying funds at about 10% of its net asset value, the proposed threshold will require fund of funds to disclose most (if not all) of their underlying investments. The result is that retail investors could be confronted with a significant amount of information on underlying investments - without the utility of that information being immediately clear - to the detriment of clear and effective disclosure. To avoid this result while at the same time meeting ASIC's policy requirement that investors be protected, AIMA submits that:
 - the threshold should be increased to at least 30 - 50% of the Australian fund's net asset value. This will allow investors to consider a fund's systemic exposure to an underlying fund; and
 - it would be more efficient and effective for an issuer of complex products to have (and disclose) its due diligence process in respect of underlying investments (including key service providers and appropriate risk management systems).
 - A fund may regularly change the size of its investments. To disclose the reduction of old holdings below the appropriate threshold and the introduction of new holdings above the threshold would impose an unnecessarily cumbersome obligation on an issuer of complex products. It would also be difficult for fund managers to assess if increasing or reducing an investment above or below the threshold is adverse to members' interests - presumably the fund manager considers the change not to be adverse, although

the correctness of this conclusion would only be apparent with time. Given the difficulties around this assessment and the difficulties associated with ongoing disclosure of the size of investments, AIMA submits that ASIC should confirm that this disclosure need only be made in the initial PDS and thereafter in the fund report contemplated by Proposal C12.

- **Proposal C5: Assets and Asset Location**

AIMA suggests that ASIC clarify what it means by 'asset location' in Proposal C5(c). Is this the geographic location of the actual asset or of the holder of the asset (eg, the custodian)? If the former, in the case of a security or financial product, is the location of the security the location of the issuer of that security or financial product, or the location of the exchange (if the security or financial product is listed - in which case a dual-listed share may have two geographic locations).

- **Proposal C8: Liquidity**

AIMA notes that the criteria for being a simple managed investment scheme and accordingly part of the short PDS regime is based on liquidity. However, the liquidity threshold for a simple managed investment scheme, and this Proposal C8 are different. It is queried whether it is necessary to have different liquidity thresholds.

Although it will depend on the individual fund's investment strategy, the proposed 20% liquidity level is generally acceptable under normal market conditions. However, this threshold may not be appropriate in the event of an unusual market event.

A fund's illiquid assets may rise above or fall below 20% during the course of a year. To disclose these fluctuations by way of a PDS or supplementary PDS could impose a significant cost on funds. AIMA submits that ASIC should confirm that this disclosure need only be made in the initial PDS or the first time that the fund trips the 20% threshold and thereafter in the fund report contemplated by Proposal C12.

- **Proposal C9: Leverage**

- It is noted that leverage can be used for managing risk as well as for increasing exposure to investment returns. When preparing a PDS, especially for a new fund, it will be difficult for the issuer to know the anticipated level of leverage. If a level is required to be disclosed, many issuers will adopt a conservative approach and disclose a likely range. AIMA requests that ASIC confirm this is acceptable.
- AIMA requests ASIC to clarify whether the level of leverage should be disclosed as a net or gross figure. AIMA submits that the net amount is more appropriate, as the disclosure of gross leverage may imply more risk in the fund than in fact exists.
- Related to the issue of leverage, is whether issuers are required to disclose prime brokerage arrangements and, in particular, collateral

and rehypothecation limits. Disclosure of these concepts may have two adverse effects:

- First, they may be confusing to retail investors and, as a result, make a PDS less clear, concise and effective.
- Precise disclosure of information such as rehypothecation limits may result in effective disclosure of the fee that a fund is paying its prime broker, which is sensitive and confidential information.

AIMA submits that these considerations support the disclosure of an anticipated leverage range (rather than specific leverage).

- The proposal requires a fund to disclose the providers of leverage. These are likely to change over the life of a fund. AIMA requests that ASIC confirm that compliance with this requirement simply requires the disclosure of the class or type of leverage provider and not the actual providers. Alternatively, if specific disclosure is required, AIMA requests that ASIC confirm that it need only be made in the initial PDS and thereafter in the fund report contemplated by Proposal C12.

- **Proposal C12: Periodic Reporting**

- AIMA notes that much of the information listed in Proposal C12 is already disclosed in funds' audited annual reports, which are available to all unitholders. AIMA submits that funds not be required to disclose information in their C12 reports to the extent that they already disclose it to investors in other documents.
- AIMA submits that it will not be possible for funds to disclose their leverage ratios as contemplated in Proposal C12(e) and that this requirement should be removed. The requirement to include embedded leverage would require a fund which invests in listed equities (for example, BHP) to assess BHP's leverage and extrapolate how that leverage impacts on their own leverage ratio. For fund of funds which invest in several underlying funds, each of which is likely to be invested in several listed securities, the difficulties are multiplied.

4. **Timeframe and impact**

As noted in above, it will be beneficial if ASIC could confirm as soon as possible that hedge funds will be excluded from the requirement to prepare a short form PDS. There will be significant implementation costs if product issuers need to prepare a short form PDS and are later required to revert to a long form PDS to comply with the enhanced disclosure regime contemplated in CP147.

Contact points

AIMA Australia contacts in respect of this Submission are:

Nikki Bentley
Hon Legal Counsel and Chair of the
Regulatory Committee of AIMA Australia
C/- Henry Davis York
Tel: (02) 9947 6245
Email: nikki_bentley@hdy.com.au

Authorship of this Submission

This Submission was prepared by a Working Group of the AIMA Australia Regulatory Committee comprising Kim Ivey (AIMA Australia), Nikki Bentley (Henry Davis York), Marc Kemp (Allens Arthur Robinson), Simon Ibbetson (358Australia) and Lindsay Jones (Lanterne Strategic Investors).