

BOARD NOTICE 571 OF 2008**FINANCIAL SERVICES BOARD****FINANCIAL ADVISORY AND INTERMEDIARY SERVICES ACT, 2002
(ACT NO. 37 OF 2002)****HEDGE FUND FSP RISK DISCLOSURES**

Under section 8A.2(b) of the schedule to the Notice on Codes of Conduct for Administrative and Discretionary FSPs, 2003, I, Dube Phineas Tshidi, Registrar of Financial Services Providers, hereby determine the format of the disclosure by a hedge fund FSP of the risks involved in hedge funds, and the following matters regarding thereto-

- (a) Hedge fund FSPs must in writing disclose to clients the risks and other characteristics of hedge funds as provided for in the schedule of this Notice;
- (b) Hedge fund FSPs must ensure that clients understand the risk disclosures;
- (c) The disclosures in the schedule do not cover all risks that may arise from investing in a particular hedge fund portfolio. A hedge fund FSP must therefore augment the disclosures in the schedule to include all other risks and hedge fund characteristics that are identified, and peculiar to a specific hedge fund portfolio.
- (d) In this Notice and the schedule, unless the context indicates otherwise-
 - (i) Any word or expression shall have the meaning that it was assigned in the Financial Advisory and Intermediary Services Act, No. 37 of 2002, (including any measure contemplated in the definition of "this Act" as defined in section 1(1) of the Act);
 - (ii) "short selling", means selling securities short in anticipation of being able to buy them back in the future at a lower price.

This Notice is called the Notice on Hedge Fund FSP Disclosures, 2008, and comes into operation on the date of publication of this Notice in the Gazette.



D P Tshidi
Registrar of Financial Services Provider

SCHEDULE

HEDGE FUND FSP RISK DISCLOSURES

The hedge fund FSP risk disclosures.

1. The risks and characteristics contained in this schedule and outlined immediately hereunder represent some of the more general risks and characteristics prevalent in hedge fund portfolios. The list below should not be seen as exhaustive. As more risks and characteristics are identified that were not initially mentioned in this schedule, then such risks and characteristics will, as they become prevalent, be included herein.

1.1 Investment strategies may be inherently risky

Hedge fund strategies may include leverage, short-selling and short term investments. In addition, hedge fund portfolios often invest in unlisted instruments, low-grade debt, foreign currency and other exotic instruments. All of these expose investors to additional risk. However, not all hedge fund managers employ any or all of these strategies and it is recommended that investors consult their advisers in order to determine which strategies are being employed by the relevant manager and which consequent risks arise.

1.2 Leverage usually means higher volatility

Hedge fund managers may use leverage. This means that the hedge fund manager borrows additional funds, or trades on margin, in order to amplify his investment decisions. This means that the volatility of the hedge fund portfolio can be many times that of the underlying investments. The degree to which leverage may be employed in any given hedge fund portfolio will be limited by the mandate the client has with the manager. The limits laid down by the mandate should be carefully reviewed in making an investment decision.

1.3 Short-selling can lead to significant losses

Hedge fund managers may borrow securities in order to sell them short, in the hope that the price of the underlying instrument will fall. Where the price of the underlying instrument rises, the client can be exposed to significant losses, given that the manager is forced to buy securities (to deliver to the purchaser under the short sale) at high prices.

1.4 Unlisted instruments might be valued incorrectly

Hedge fund managers may invest in unlisted instruments where a market value is not determined by willing buyers and sellers. The hedge fund manager may have to estimate the value of such instruments, and these estimates may be inaccurate, leading to an incorrect impression of the fund's value. Investors should ensure that objective valuations are performed for all instruments in a portfolio and that the manager utilises the services of a competent administrator.

1.5 Fixed income instruments may be low-grade

Hedge fund managers may invest in low-grade bonds and other fixed interest investments. These investments are more likely to suffer from defaults on interest or capital. They are also more likely to have volatile valuations when the market changes its view on credit risk. The mandate should also limit the extent (i.e. lowest acceptable rating and maximum percentage exposure) to which low grade debt can be acquired by the client. Investors should review the mandate to gain an appreciation of the maximum possible exposure applicable to the relevant mandate.

1.6 Exchange rates could turn against the fund

A hedge fund manager might invest in currencies other than the base currency. For example, a South African hedge fund manager might invest in UK or US shares. The portfolio is therefore exposed to the risk of the rand strengthening or the foreign currency weakening.

1.7 Other complex investments might be misunderstood

In addition to the above, hedge fund managers might invest in complex instruments such as but not limited to futures, forwards, swaps, options and contracts for difference. Many of these will be derivatives, which could increase volatility. Many will be "over-the-counter", which could increase counterparty risk. Many exotic instruments may also be challenging for the manager to administer and account for properly. Investors should enquire into how these instruments are objectively and independently valued.

1.8 The client may be caught in a liquidity squeeze

Given their often short term nature, hedge fund managers need to be able to disinvest from or close certain positions quickly and efficiently. But market liquidity is not always stable, and if liquidity were to decrease suddenly, the hedge fund manager might be unable to disinvest from or close such positions rapidly or at a good price, which may lead to losses.

1.9 The prime broker or custodian may default

Hedge fund managers often have special relationships with so-called "prime" brokers. These are stock-brokers that provide the required leveraging and shorting facilities. Prime brokers usually require collateral for these facilities, which collateral is typically provided using assets of the relevant client, and consequently such collateral might be at risk if the prime broker were to default in some way. A similar situation could occur with the custodian of the client's funds.

1.10 Regulations could change

Legal, tax and regulatory changes could occur during the term of the investor's investment in a hedge fund portfolio that may adversely affect it. The effect of any future legal, tax and regulatory change or any future court decision on a hedge fund portfolio could be substantial and adverse.

1.11 Past performance might be theoretical

Hedge fund portfolios are on occasion marketed using theoretical or paper track records. Past performance is seldom a reliable indicator of future performance. Theoretical past performance is often an even less reliable indicator, and investors should place a lower significance on these.

1.12 The manager may be conflicted

The hedge fund manager might be managing other hedge fund portfolios or other traditional investment funds. The investor should ensure that sufficient controls are in place to manage any conflicts of interest between the different funds.

2. The other differences in hedge fund portfolios**2.1 Hedge fund structures are often complex**

As mentioned above, hedge funds structures are not fully regulated and they are often housed in legal structures not originally meant for pooled funds, for example partnerships and companies. Given the many risks listed above, investors need to ensure that any structure is robust enough to contain any unlimited losses.

2.2 Manager accountability may be vague

Hedge fund portfolios are often managed by specific individuals and investors should ensure that sufficient controls are in place for the times when the manager is being covered for by colleagues. In addition, a hedge fund structure (for example, a fund of funds) and its managers or advisors may rely on the trading and/or investing expertise and experience of third-party managers or advisors, the identity of which may not be disclosed to investors. This constitutes an additional risk for investors, which they must take into account.

2.3 Fees might be high

Hedge fund structures fees may be significantly higher than the fees charged on traditional investment funds. Investments should be made only where the potential returns justify the higher fees.

2.4 Fees might be performance-based

Hedge fund manager's fees are usually performance-based. This means that the managers typically get a higher fee when their portfolios outperform specified performance targets, which might lead to riskier positions being taken. Investors need to ensure that performance fees allow for a fair sharing of both the good and the bad.

2.5 Transaction costs might be high

Given the often short term nature of investment positions, hedge fund portfolios are often traded more aggressively. This implies more stock-broking commission and charges being paid from the portfolio, which is ultimately for the client's account. Again investments should be made only where the potential returns make up for the costs.

2.6 Transparency might be low

A hedge fund manager's performance is often the result of unique proprietary strategies or contrarian investment positions. For obvious reasons, managers will want to keep these confidential. Managers are therefore less likely to disclose trades to their investors, and holdings might be disclosed only in part or with a significant delay.

2.7 Dealing and reporting might be infrequent

A hedge fund manager's performance can often be disturbed by irregular cash flows into or out of the hedge fund structure. For this reason, hedge fund managers often limit the frequency of investments and withdrawals. Similarly, the manager may choose to report infrequently on performance and other statistics. Investors should ascertain, prior to investing, the nature and frequency of reporting.

2.8 Withdrawals might not be easy

As mentioned above, the frequency of withdrawals might be limited to monthly or quarterly dates. In addition, the manager may impose notice periods or lock-ins in order to ensure that he has the necessary time for his investment positions to deliver their desired results.
