STATEMENT SUPPORTING DRAFT NOTICE OF AMENDMENT OF BOARD NOTICE 90 OF 2014

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Financial Sector
Conduct Authority

1 PURPOSE OF THE STATEMENT

1.1 This Statement relates to the draft Notice of Amendment of the Determination of securities, classes of securities, assets or classes of assets that may be included in a portfolio of a collective investment scheme in securities and the manner in which and the limits and conditions subject to which securities or assets may be so included, published under Board Notice 90 of 2014 in Government *Gazette* No. 37895 on 8 August 2014 ("BN 90") ("draft Amendment Notice"), proposed to be made by the Financial Sector Conduct Authority ("FSCA") in terms of sections 40, 45(a)(ii) and (b)(ii), 46 and 85 of the Collective Investments Schemes Controls Act, 2002 (Act No. 45 of 2002) ("CISCA"), read with section 301(3) of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017) ("FSR Act").

1.2 This Statement is published in accordance with Section 98(1)(a)(iv) of the FSR Act and is intended to support and give context to the draft Amendment Notice that is published for public comment. The main purpose of this Statement is to explain the need for, the expected impact of, and the intended operation of the draft Amendment Notice.

2 STATEMENT OF NEED - POLICY CONTEXT AND PROBLEM DEFINITION

2.1 *Investment into actively managed exchange traded funds*

2.1.1 Currently, Exchange Traded Funds ("ETFs") are listed on the exchanges, particularly the Johannesburg Stock Exchange ("JSE"), in the following two main categories:

(a) ETFs that comply with the regulatory framework applicable to collective investment schemes ("CIS") and are registered as CIS portfolios and recognised as CIS ETF Schemes ("CIS ETFs"); and

(b) ETFs that are not required to comply with CIS laws, but with other rules prescribed by the JSE, for example commodity type funds, such as Gold ETFs or Platinum ETFs, which are not under discussion herein.

2.1.2 When ETFs were introduced in South Africa, the JSE restricted CIS ETFs to passive funds, i.e. portfolios that must track a chosen index. Consequently, the FSCA only approved investment by CISs in index tracking CIS ETFs and not also investment in other types of CIS ETFs.

2.1.3 Therefore, BN 90 currently only references investment by CIS portfolios in physical ETFs. In this regard, BN 90 defines a "physical exchange traded fund" as "*an exchange traded fund which tracks an index or the value of precious metals and which physically holds the underlying assets it is tracking;".*

2.1.4 Internationally, actively managed pooled funds are commonly listed and there is significant demand for actively managed CIS ETFs in particular.[1] Certain investors view an exchange as the preferred investment channel as it is trusted, provides a single platform offering a wide spectrum of investments and provides immediate liquidity. In addition, the JSE has previously engaged the FSCA with a proposal to amend the JSE Listing Requirements to pave the way for issuers to list and trade actively managed ETFs for the first time.

[1] Examples of international providers of listed actively managed funds include: WCM/BNY Mellon, Blackrock iShares, Invesco, Guggenheim/Claymore, Pimco, Advisorshares, etc. in the USA; Fidelity etc. in Luxembourg; and Franklin Templeton and, JP Morgan, etc. in the UK. The value traded of active ETFs on the London Stock Exchange has risen substantially from £578m in 2016 to over £110bn in 2022.

2.1.5 In this light, the FSCA is of the view that the introduction of actively managed ETFs will assist in expanding the investment universe for investors, and thus other CIS portfolios. Currently, ETFs have performed well as an investment medium in SA as well as internationally and there is little question with regards to their demand.

2.1.6 At this stage there are no obvious concerns regarding the introduction of actively managed ETFs as an additional permitted security. Actively managed ETFs will be operated and managed in the same manner as the current index tracking ETFs, it is only the investment mandate which differs.

2.1.7 The benefit of an actively managed ETF is that it is not forced to be fully invested nor to buy derivatives to ensure investment to equal the tracking of an index. Therefore, an actively managed ETF can hold more assets in liquid form, providing for more redemption liquidity in the portfolio.

2.1.8 The FSCA therefore supports creating an enabling environment for the establishment of, and investment into, actively managed CIS ETFs. As such, the FSCA approved amendments to the JSE Listing Requirements that will allow issuers to list and trade actively managed ETFs, subject to various requirements, and these amendments came into effect on 14 October 2022.

2.1.9 It should further be noted that actively managed CIS portfolios still need to comply with all the relevant CIS legislation. Other aspects in current legislation that are impacted, for example the pro forma wording for Supplemental Deeds for ETFs that require the tracking of an index and the alignment of relevant JSE rules, have already been considered and the FSCA and interested members of industry are working on appropriate changes.

2.1.10 The introduction of actively managed ETFs does not deviate from current investment fund and CIS policy; it merely expands the current narrow mandate of ETFs to permit portfolios that are already provided for in the traditional CIS space. The FSCA is also of the view that any potential risks may be suitably mitigated.

2.1.11 To further mitigate potential risk, it might be noted that the JSE Guarantee Fund (“the Fund”) provides protection to investors, up to certain limits, in the event of a member's default and the investor being unable to recover securities or funds held by the member on their behalf. Following the default of a member firm, the Fund will consider a client's claim and pay out that claim, should it be deemed to qualify. The Fund would then claim against the residual assets of the member firm. The JSE also holds fidelity insurance for its member firms.

2.1.12 The listing of actively managed CIS portfolios may create an additional layer of investor protection and security by virtue of the JSE’s supervision of the product and its involved members, in addition to the FSCA supervision. The frequent intraday trading of the fund will obviously also aid in price discovery of its shares.

2.1.13 For the reasons referred to above, the FSCA is of the view that investment by CISs in actively managed ETFs should be allowed. To give effect thereto given the time pressure of the JSE’s imminent launch of the ETF’s, on 11 November 2022, the FSCA published the FSCA CIS Notice 7 of 2022 exempting managers of CISs from the requirements set out in paragraphs 3(3)(a)(v) and 3(14)(b) of BN 90 with a view to promote financial markets, market entry and market participation (“the exemption”).

The Communication supporting the exemption also highlighted that the FSCA is intending to make targeted amendments to BN 90 to give effect to the aforementioned.

2.1.14 Certain conditions were imposed in the exemption to ensure that both the CIS managers and the investors are afforded the necessary protection and that the exemption will not prejudice the achievement of the objects of CISCA. In amending BN 90, it is important that these requirements (currently reflected as conditions of the exemption) be provided for in order to ensure sufficient protection of CIS managers and investors.

2.2 ***Increase in maximum exposure applicable to underlying portfolio, where the underlying portfolio is a foreign collective investment***

2.2.1 Paragraph 3(3)(a)(i) of BN 90 provides that a manager may include participatory interests of CIS portfolios (underlying portfolios) in a portfolio up to 80% of the market value of such portfolio, provided that any one underlying portfolio may not exceed 20% of the market value of such portfolio.

2.2.2 In addition, as indicated in South African Reserve Bank Exchange Control Circular No. 10/2022, Section B.2(H)(iv)(a)(aa) of the Currency and Exchanges Manual for Authorised Dealers (Authorised Dealer Manual) was amended and the prudential limits (previously foreign investment allowance) for offshore exposure, including the African allowance, have been combined into a single limit of 45%.

2.2.3 The FSCA has received requests from industry to increase the 20% limit per underlying portfolio to allow for a standard or hybrid portfolio to gain 45% offshore exposure by investing in one underlying foreign portfolio or one underlying domestic portfolio, such as a feeder fund, that consists only of foreign exposure.

2.2.5 To achieve the most efficient and cost-effective exposure to foreign assets, it is current industry practice to invest in foreign portfolios as opposed to investing directly into foreign securities. These foreign portfolios are often part of a foreign scheme managed and operated by a company within the same group as the management company or the investment manager managing the assets of the portfolio.

2.2.4 However, one of the effects of the new prudential limit entails that if a manager wishes to implement the maximum foreign exposure as provided for in the prudential limits, through investment in underlying foreign portfolios or a domestic portfolio consisting only of foreign exposure, an investment in at least three foreign exposure portfolios will be required (as the current limit per portfolio in BN90 is reflected as 20%). This impedes the efficient implementation of an investment to gain foreign exposure.

2.2.5 In terms of paragraph 10(a) of BN 90, a fund of funds must invest in at least two underlying portfolios, and the investment in any one portfolio may not exceed 75% of the market value of the fund of funds. While a standard or hybrid portfolio cannot be compared to a fund of funds, the requirements to invest in an underlying foreign portfolio is similar. Put differently, in terms of subparagraphs 3(3)(a)(ii) and (iii) of BN 90, a standard or hybrid portfolio may only invest in foreign portfolios subject to due diligence and an annual review for compliance with section 65 of CISCA. In circumstances where the underlying portfolio is managed by the same CIS Manager or another company linked to the CIS Manager, no manager's charge may be charged on the underlying portfolio. There is no clear additional risk in standard or hybrid portfolios to justify imposing a far lesser limit (20%) when investing in an underlying foreign portfolio. In the FSCA's view, an approach to an extent aligned with the approach to fund of funds could be regarded as reasonable.

2.2.6 Further consideration is that the percentile investment limits, such as the 20% per portfolio, is aimed at maintaining investment diversification to "soften" loss risks. However, an underlying portfolio of the kind permitted for investment by a South African CIS portfolio must already be properly diversified.

2.2.7 In light of the above, the FSCA is of the view that the 20% investment limit per underlying portfolio applicable to standard or hybrid portfolios for investments in foreign portfolios or domestic portfolios consisting only of foreign exposure, should be increased to 45%, subject to the provisions of its supplemental deed.

2.3 *Investment into hedge funds*

2.3.1 Pension funds are currently permitted to invest in retail hedge funds, subject to a limit prescribed in Regulation 28 of the Regulations in terms of section 36 of the Pension Funds Act 1956 (Act No. 25 of 1956) ("PFA"), published by Government Gazette No. 37895 162 of 26 January 1962 (as amended) ("Regulation 28").

2.3.2 In terms of the conditions pertaining to CIS in securities, contemplated in BN 90, CIS in securities may not invest in retail hedge funds. This could be ascribed to the fact that hedge funds were not regulated at the time that BN 90 was promulgated and therefore lacked regulatory oversight.

2.3.3 In 2015, the necessary regulatory instruments under CISCA were promulgated to introduce the regulation and supervision of hedge funds in South Africa.[2]

2.3.4 Many of approved CIS in securities' portfolios determine in their approved investment policies (as contained in their approved supplemental deeds) that such portfolios will comply with the spread requirements and investment limits as prescribed by Regulation 28. Whilst pension funds may thus invest in hedge funds, Regulation 28-compliant CIS in securities may not as it is not a permitted investment for CIS in securities. This has resulted in an unlevel playing field between the asset management industry serving pension funds and CIS in securities' portfolios that aim to fulfil the same role.

2.3.5 In previous interactions with the industry, the FSCA expressed its view that hedge funds were promulgated and established as a distinctly different and separate type or class of collective investment scheme that was intended to have the ability of operating at differing strategy application or risk levels. Thus, the possibility of having a CIS in securities highly exposed to the same possible risks as hedge funds and the distinct differences (e.g., differing liquidation periods) did not follow the intended separation. The FSCA acknowledged that, as retirement funds may have a limited exposure to hedge funds, it is amenable to consider allowing for a similar exposure to hedge funds by CIS in securities that are approved, operate and are marketed as CIS in securities portfolios that comply with the investment limits as determined in terms of Regulation 28 of the PFA.

2.3.6 From the aforesaid interactions, proposals were submitted by industry for the inclusion of hedge funds in CIS in securities, which set out the advantages of including CIS in

[2] Board Notice 52 of 2015.

retail hedge funds as a security, but also considered the risks associated with these investments and the possible mitigation of those risks. The risks mainly relate to those that are commonly associated with investing in hedge funds and liquidity of hedge funds. However, hedge funds are now properly supervised by the FSCA and the investment limit in accordance with Regulation 28 limits the loss potential. With regards to the liquidity risk, it is proposed that only hedge funds with daily pricing and transacting be permitted.

2.3.7 In addition, concerns were raised by the industry that CIS in securities could not invest in hedge funds whilst hedge funds are available to retail investors. Further concerns were raised about the viability of the hedge funds industry and the fact that the delay in finalisation of the inclusion was detrimental to the hedge funds industry.

2.3.8 The FSCA's mandate to support the development of the industry must also be considered in this instance. Allowing CIS in securities funds to access hedge funds will support growth in the hedge fund industry. Growth will assist with the reduction of increased costs associated with the regulation of CIS in hedge funds. It may also assist the industry to attract new boutique asset managers. If, through Linked Investment Service Providers (LISPs), pension fund investors allocate 10% to hedge funds, it is estimated that the industry will grow by R25.7billion (estimated at 2016 figures).

2.3.9 Statistics indicate that in excess of R857 billion from Retirement Annuities, Preservation, Pension and Provident Funds is invested in CIS in securities through LISPs. It is proposed that these investors must have the opportunity to invest in hedge funds as allowed by Regulation 28 and therefore the Regulation 28 limits for hedge funds must be applicable to a CIS in securities investing in a CIS in hedge funds. This will be beneficial for portfolio diversification which these clients are not benefiting from.

2.3.10 The investing public do not all have access to formal pension funds. CIS in securities that are Regulation 28 complaint have filled this void. Furthermore, less sophisticated pension funds have found it very helpful to be able to invest in Regulation 28 complaint CIS funds. However, level playing fields should be provided with regards to the investments that these CIS may make, as they all have a specific purpose for the benefit of the investors. There are clear benefits for including hedge funds in a CIS in securities portfolio. Hedge funds can reduce the overall risk of the portfolio, minimise drawdowns and generate a smoother return profile for investors.

2.3.11 The FSCA is of the view that CIS in securities that have a mandate to comply with Regulation 28 should be permitted to invest in retail hedge funds, subject to the same limits that apply to pension funds in terms of Regulation 28 and subject thereto that the retail hedge fund prices and repurchases daily. This would have the effect that the Regulation 28-compliant CIS in securities portfolios will be used as underlying assets or "building blocks" for pension funds with similar exposures. These CIS in securities portfolios is also subject to the same requirements for audit and certification of compliance to enable it to be used as such.

2.3.12 The requirement for daily pricing and repurchasing is to ensure a matched liquidity profile of the CIS in securities portfolio and an underlying hedge fund.

2.3.13 Lastly, the FSCA is in the process of reviewing of BN 90 holistically in conjunction with the Prudential Authority. The review will, however, be of a very technical nature that will take considerable time to complete and will require extensive consultation. Accordingly, the FSCA is of the view that an amendment to BN 90 will be able to produce the most appropriate solution to the issues set out above, given the urgency for level playing fields, pending the finalisation of the review.

3 SUMMARY OF THE DRAFT AMENDMENTS TO BN 90

In the above context, the proposed amendments are limited and consist of the following:

3.1 *Investment into actively managed exchange traded funds - Amendments to paragraphs 1, 3(3)(a)(v) and 3(14)(b)*

3.1.1 The amendments to paragraphs 1, 3(3)(a)(v) and 3(14)(b) are aimed at facilitating investment into actively managed funds. The amendments include changes to:

- the definitions of “physical exchange traded fund” and “physical exchange traded notes” to include a reference to actively managed exchange traded funds; and
- paragraphs 3(3)(a)(v) and 3(14)(b), to perpetuate the conditions of the current exemption (see paragraph 2.1.14 above).

3.1.2 It should be noted that the condition in the current exemption requiring that an actively managed exchange traded fund must be approved as a portfolio of a registered CIS was not included in the amendments as, by virtue of the substitution of the abovementioned definitions, being an approved portfolio of a registered CIS is already applicable in terms of CISCA.

3.1.3 In addition, the draft Amendment Notice has been written in such a manner that the conditions contained in the current exemption is applicable to both physical exchange traded funds that relies on passive index tracking, as well as actively managed exchange traded funds, as-

- the prohibition to invest in synthetic financial instruments is already applicable to passive exchange traded funds and included in the requirements in the substituted paragraph 3(3)(a)(v) for the sake of clarity that the prohibition applies to both types of exchange traded funds; and
- it would be beneficial to investors if the differences between the two types of exchange traded funds are explained when investing in either.

3.2 *Increase of maximum exposure to foreign CIS portfolio - Amendment of paragraph 3(3)(a)(i)*

3.1.1 The amendment of paragraph 3(3)(a)(i) is aimed at increasing the limit of the exposure to foreign CIS portfolios. The amendment proposes to insert a reference to a 45% limit in instances where the underlying portfolio is a foreign CIS.

3.1.2 This proposed amendment aligns the requirements of BN 90 with the requirements in the Authorised Dealer Manual, thereby promoting maximum foreign exposure. This further accommodates a CIS portfolio by allowing it to invest in a single foreign portfolio rather than three separate foreign portfolios.

3.3 Investment into hedge funds **-** *Insertion of new paragraph 3(20)*

3.3.1 The insertion of paragraph 3(20) is aimed at facilitating investment by Regulation 28-compliant CIS in securities into retail hedge funds. The amendment introduces a new subparagraph which allows investment by a CIS in securities in a retail hedge fund, subject thereto that the–

- portfolio’s investment policy requires compliance with Regulation 28;

- portfolio was approved by the FSCA on the basis of compliance with Regulation 28; and
- retail hedge fund in which it invests prices and repurchase on a daily basis.

3.3.2 The proposed amendment will level the playing field between the asset management industry serving pension funds and CIS in securities' portfolios. Ultimately this will benefit of the investors as they will have access to these funds, thus ensuring the protection of such investors and the promotion of the aims and objects of CISCA.

4 STATEMENT OF IMPACT OF THE AMENDMENT TO BN 90

4.1 The Amendment Notice is envisaged to have an immediate impact on the ability of–

(a) managers of CISs to invest in actively managed ETFs, without the need to rely on an exemption, which was intended to be an interim solution;

(b) portfolios to gain 45% offshore exposure as opposed to the current 20% limit; and

(c) CIS in securities that compete in the retirement funds industry to include exposure to retail hedge funds on an equal footing as other retirement funds.

4.2 As mentioned above, the FSCA does not believe that there should be any real concerns regarding the introduction of actively managed ETFs as newly registered CIS portfolios, and as an additional permitted security, as it is not envisaged to have any potential negative affect on investors or the financial market. On the contrary, the introduction of actively managed ETFs broadens the investment markets, which also assists in liquidity in the financial market. It further provides for investments in CIS in securities for those investors who prefer ongoing price disclosure and trading on an exchange and , as many local and foreign investors prefer investing on the JSE. Actively managed ETFs will operate and be managed in the same manner as the current index tracking ETFs, except for the fact that it will not be tracking an index.

4.3 Despite minor systems adjustments and possible expansion of certain compliance processes that will be required, the FSCA does not expect a substantial financial impact for the CIS in securities industry if they are allowed to invest in retail hedge funds. One of the benefits is that their Regulation 28-compliant portfolios will be more competitive and attractive to pension fund investors and retirement funds that wish to have a hedge fund exposure. Thus, it may increase its marketability. Further it is anticipated that the costs of additional administration and compliance functions will be minimal for the managers of CIS in securities portfolios that include retail hedge funds.

4.4 The inclusion of retail hedge funds will generally assist in the facilitation of hedging in the CIS in securities portfolios and enhance the efficient portfolio management.

4.5 As a sub-industry, CIS retail hedge funds will be able to market and provide their products to CIS in securities portfolios that are managed in terms of the diversification limits of regulation 28 of the Pension Funds Act. This is expected to increase the profitability and support the financial survival of the hedge funds industry.

4.6 It is believed that an increase in the limit for foreign underlying portfolios or domestic portfolios consisting only of foreign exposure will not introduce any risk which is not appropriately mitigated by other BN90 provisions. An increase in the limit will improve efficient implementation of foreign exposure.

4.7 It needs to be borne in mind that a permitted foreign fund is already properly diversified and concerns relating to the maintenance of diversification are minimal and the argument for overdiversification can also be made if the 20% is maintained. Accordingly, the increased exposure has very little impact to the investor. Allowing for the possibility of a single underlying foreign fund is more administratively- and cost efficient. There is very little impact on a manager in the managing of a portfolio with a revised asset limit.

5 STATEMENT OF INTENDED OPERATION OF THE AMENDMENT TO BN 90

5.1 The draft Amendment Notice is consistent with the objects of the FSR Act and CISCA, and specifically the mandate of the FSCA.

5.2 The draft Amendment Notice is intended to become effective on the date of publication.

5.3 Following the implementation of the Amendment Notice, the Authority will assess and evaluate the effect of the amendments on a continuous basis as part of its regulatory and supervisory responsibilities.