

■ A NUMBER OF FOREIGN-DOMICILED FUNDS HAVE DEREGISTERED

Investors are missing the boat to go offshore



One of the easiest ways to invest offshore is to buy unit trusts that do it for you – and now's a good time. But fund managers feel local regulations restrict your foreign investment choices, writes **Laura du Preez**.

Fund managers say now is a good time to invest offshore as many offshore markets are well priced and set to deliver good returns, while the rand is currently strong but likely to depreciate in the future, boosting your offshore returns.

However, local fund managers say South African investors are being denied broader opportunities to invest offshore because local collective investment scheme regulation remains tightly controlled and out of step with that of other countries.

A number of foreign-domiciled funds that were registered in South Africa have deregistered lately and industry sources cite local regulation as the reason for this.

According to the Association for Savings & Investments SA (Asisa), the number of foreign currency denominated funds on sale in South Africa dropped from 372 funds at the end of 2009 to 336 at the end of 2010.

Last year, four offshore managers deregistered all their funds.

Local fund managers also say rand-denominated funds of funds (FoFs) that invest in funds focused on foreign markets are restricted in their choice of underlying funds and this is making them hesitant to launch new FoFs.

Pieter Koekemoer, the head of personal investments at Coronation, says investors have much less choice of foreign investments than they could have had if local regulations were in line with those in other countries that offer mutual funds.

But the Financial Services Board (FSB) says these allegations are inaccurate. It says collective investment schemes are not the only way to access offshore investments.

Secondly, it says, local regulation differs from that of other reputable jurisdictions in that in South Africa

managers must observe additional investor protection provisions.

The FSB will not register foreign managers wanting to market funds whose investments focus on unlisted securities or who engage in the risky practice of borrowing to invest (gearing). You are, however, free to invest in non-registered funds of your own accord, but you have no recourse to the FSB.

Bert Chanetsa, the deputy executive officer at the FSB in charge of investment institutions, says the FSB plans to change current regulations to address one of the difficulties local managers face when investing offshore through FoFs.

However, unit trust industry proposals to allow much wider investment powers to funds you can access from South African managers or offshore managers registered in South Africa were taken off the table after the 2008 credit crisis.

Chanetsa says the regulator wants to ensure the funds offered to you under its auspices and in terms of current law invest primarily in listed securities that can be easily valued and liquidated so that you have quick access to your money.

Patrick Ward, the FSB's head of collective investment schemes, says foreign fund managers have deregistered from South Africa for a variety of reasons. A likely reason is the lack of local demand for offshore funds. He says that, in the wake of the 2008 crisis, fund managers across the world have rationalised the funds they offer to investors.

EU GUIDELINES START TROUBLES
Fund managers' problems began in 2007 when the Undertakings for Collective Investment in Transferable Securities III (Ucits III) became effective as the standard for

Many foreign-domiciled funds fail to make the grade as suitable funds to be marketed to South Africans under the auspices of the Financial Services Board (FSB) because the entities that have custody of their assets are not independent from the funds' other service providers.

South Africa's Collective Investment Schemes Control Act (Cisca) requires fund managers to appoint independent custodians and trustees who ensure funds' assets are held separately from the business of the unit trust company or its fund managers and that funds adhere to their mandates. In South Africa, funds' trustees typically perform the custodial services.

Peter Blohm of the Association for Savings & Investments SA (Asisa) says funds domiciled in other countries

collective investment schemes that were to be marketed across the European Union (EU).

In effect, Ucits III regulates hedge funds as well as collective investment schemes, while South Africa's Collective Investment Schemes Control Act (Cisca) currently does not regulate hedge funds.

Peter Blohm, a senior policy adviser to the Asisa, says the FSB registers international funds if they comply with certain Cisca requirements.

South African-domiciled rand-denominated FoFs that invest in foreign markets, in turn, are allowed to invest in foreign funds that are not registered with the FSB, but the funds in which they invest must comply with Cisca.

Ucits III introduced broader investment guidelines for EU funds,

CUSTODIAN ISSUES

often separate the oversight and custodian services and contract big banks to provide both custodial services and administration of their funds. The FSB is of the view that this practice is not aligned with Cisca requirements.

Blohm says in 2004 the Association of Collective Investments (which later become part of Asisa) drafted guidelines suggesting that the oversight of funds and custodial services should be separated, but the FSB is disregarding these guidelines and is interpreting the law strictly.

Coronation's Pieter Koekemoer

but South African registered funds are prohibited from making use of some of these powers.

For example, local funds can only use derivatives to the extent that they have matching underlying investments – they can only short an index or a share to the extent that they hold that index or share. Ucits III funds can short a share or index without holding it, giving the fund a geared position and resulting in higher or lower returns than it would earn from holding a share or index.

Local funds may currently only invest 10 percent of the fund in over-the-counter (unlisted) instruments if those instruments will list within a year.

Proposed changes to Cisca regulations will change this so that, like Ucits III funds, local funds can

says this means the vast majority of European funds cannot register in South Africa or be used as underlying funds in local funds of funds.

He says Cisca needs to be updated to reflect the reality of how markets work and doing so would not weaken investor protection.

The FSB's Patrick Ward says the FSB will continue to insist that funds registered in South Africa obtain custodian services from an entirely separate entity. He says genuine independence affords greater security than when services are offered by companies within a group, even if the company says they are separated by "Chinese walls".

Ward says an independent custodian prevented Fidentia from plundering the unit trust funds of MCubed and perpetrating fraud.

invest 10 percent in unlisted equities without the requirement that these list within a year, the FSB says.

The FSB will not recognise over-the-counter markets as listed ones, as Ucits III funds can do, as these markets are not regulated, it says.

Local funds can borrow only up to 10 percent of the value of the fund as a bridging measure to pay out investors who are disinvesting or to make new investments pending payment for investments sold.

Ucits III funds can use borrowing or gearing to a much greater extent but may not go net short, risking losses greater than the capital invested in the fund, Blohm says.

The FSB is of the view that tactics such as gearing, shorting and significant exposure to unlisted or over-the-counter instruments belong more in the hedge funds than in

collective investment schemes that invest in listed securities.

Hedge funds are currently not regulated (although hedge fund managers must be licensed). The FSB and National Treasury are currently working on an initiative to regulate hedge funds, and Chanetsa says this may or may not be through Cisca.

UCITS FUNDS SHUT OUT

Blohm says when Ucits III was introduced, most European-domiciled collective investment schemes changed their prospectuses to allow them to take advantage of the broader investment powers. But these funds could then not be registered in South Africa, even if they did not make use of these expanded powers.

The FSB issued a notice saying that funds with prospectuses stating they were Ucits III-compliant could register in South Africa if they complied with local requirements.

The FSB agreed to allow offshore funds with Ucits III-compliant prospectuses but which were registered in Ireland, Luxembourg and the UK to register in South Africa. However, it did not make the same concession for foreign-domiciled funds into which South African FoFs invest.

Blohm says offshore fund managers will not amend their prospectuses in order to attract South Africans' relatively small investment amounts, and the cost of changing the prospectuses is too high.

Ward says the FSB is amending a Cisca notice to address this issue. The matter was recently discussed with industry representatives and the proposal is expected to be published for comment before the end of this month.

Some fund managers hit harder than others

The regulatory problems with foreign funds have frustrated some managers more than others.

Prudential Portfolio Managers, for example, offers a rand-denominated Global Value Fund of Funds (FoF) that invests in the funds of its British parent company, Prudential, and its investment division, M&G.

While most of the underlying funds have been registered with the Financial Services Board (FSB), the FoF has been prevented from investing in some Prudential and M&G funds because these funds comply with the Undertakings for Collective Investment in Transferable Securities III (Ucits III).

Prudential's managing director of unit trusts, John Kinsley, says that this impasse is extremely frustrating. The FoF has invested in foreign exchange traded funds, such as the iShares S&P Global 100 index fund.

"This is not our first choice, but we had to meet the needs of our investors," Kinsley says.

Coronation's Pieter Koekemoer says the regulatory gap has resulted in Coronation offering new international funds in rand and offshore versions rather than as an offshore fund and a rand-based feeder fund, despite the fact that using feeder funds would achieve greater economies of scale.

Michael King, a director for Africa for Franklin Templeton Investments, says the FSB does not need to allow local funds the full range of Ucits III investment powers, but could be more flexible to bring South Africa closer in line with the rest of the world's fund regulations.

Franklin Templeton has 41 funds registered in South Africa – mostly international equity, property and money market funds. The group would like to register more but some Ucits III funds do not meet local restrictions, which state that:

◆ 90 percent of a fund's securities must be listed on markets that are members of the World Federation of Exchanges;

◆ 90 percent of a fund's interest-bearing instruments must be rated investment-grade; and

◆ Derivatives can only be used for efficient portfolio management, that is to reduce risk.

King says these requirements could be relaxed while maintaining a high level of investor protection.

He says the limitations on the funds and markets in which local funds can invest affect investors' yields as they may miss out on global investment opportunities.

