



**ASIC**

Australian Securities & Investments Commission

## CONSULTATION PAPER 174

# Hedge funds: Improving disclosure—Further consultation

February 2012

### About this paper

This consultation paper follows Consultation Paper 147 *Hedge funds: Improving disclosure for retail investors* (CP 147) and seeks further feedback on our proposals to improve disclosure for hedge funds.

It includes a draft regulatory guide that sets out our proposed benchmarks and disclosure principles to help investors better understand and assess such investments.

In seeking to improve disclosure, ASIC aims to ensure that investors and their advisers have the information they need to make an informed investment decision. However, this should not be regarded as an indication that we consider these products to be suitable for all or most retail investors.

## About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

**Consultation papers:** seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

**Regulatory guides:** give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

**Information sheets:** provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

**Reports:** describe ASIC compliance or relief activity or the results of a research project.

## Document history

This paper was issued on 23 February 2012 and is based on the Corporations Act as at the date of issue.

## Disclaimer

The proposals, explanations and examples in this paper do not constitute legal advice. They are also at a preliminary stage only. Our conclusions and views may change as a result of the comments we receive or as other circumstances change.

# Contents

<b>The consultation process .....</b>	<b>4</b>
<b>A Background .....</b>	<b>5</b>
Improving disclosure for hedge funds—Initial consultation .....	5
Responses to CP 147—Further consultation .....	6
<b>B Proposed disclosure guidance for hedge funds .....</b>	<b>7</b>
Scope of our disclosure guidance .....	7
Benchmarks and disclosure principles for hedge funds .....	9
<b>C Regulatory and financial impact .....</b>	<b>11</b>
<b>Attachment: Draft regulatory guide.....</b>	<b>12</b>
<b>Key terms .....</b>	<b>41</b>

# The consultation process

You are invited to comment on the proposals in this paper, which are only an indication of the approach we may take and are not our final policy.

As well as responding to the specific proposals and questions, we also ask you to describe any alternative approaches you think would achieve our objectives.

We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

Where possible, we are seeking both quantitative and qualitative information. We are also keen to hear from you on any other issues you consider important.

Your comments will help us develop our policy on disclosure by hedge funds. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account if we prepare a Regulation Impact Statement: see Section C, 'Regulatory and financial impact', p. 11.

## Making a submission

We will not treat your submission as confidential unless you specifically request that we treat the whole or part of it (such as any financial information) as confidential.

Comments should be sent by 19 April 2012 to:

Geoffrey Leveritt  
 Senior Lawyer, Strategic Policy  
 Australian Securities and Investments Commission  
 GPO Box 9827  
 Melbourne VIC 3001  
 facsimile: 03 9280 3306  
 email: [policy.submissions@asic.gov.au](mailto:policy.submissions@asic.gov.au)

## What will happen next?

<b>Stage 1</b>	23 February 2012	ASIC consultation paper and draft regulatory guide released
<b>Stage 2</b>	19 April 2012	Comments due on the consultation paper
<b>Stage 3</b>	mid-2012	Regulatory guide released

## A Background

### Key points

Hedge funds can pose more diverse and complex risks for investors than traditional managed investment schemes. This is because of their diverse investment strategies, in many cases involving the use of leverage and complex and offshore structures.

In Consultation Paper 147 *Hedge funds: Improving disclosure for retail investors* (CP 147), we consulted on introducing benchmarks and disclosure principles, setting out the specific features and risks of hedge funds that we think should be addressed in a Product Disclosure Statement (PDS) for these products.

Based on responses to CP 147, we have refined our proposals and are seeking further feedback from stakeholders on the proposed disclosure guidance attached to this paper.

## Improving disclosure for hedge funds—Initial consultation

- 1 In February 2011, we released Consultation Paper 147 *Hedge funds: Improving disclosure for retail investors* (CP 147). This paper sought feedback on our proposals to improve disclosure for hedge funds.
- 2 As stated in CP 147, our proposed disclosure guidance was not designed to stop or discourage investors from taking investment risks, but to help them and their advisers understand the risks involved in any particular investment or type of investment. This enables them to make a more informed decision about whether the potential reward (the return on their investment) warrants the level of risk involved.
- 3 Given the risks for investors associated with investing in hedge funds, and that many investors and their advisers rely on disclosure material to inform their decisions to invest, we think it is necessary to ensure that disclosure gives investors the information they need to make an informed investment decision. In some cases, this may include a decision not to invest in these products.
- 4 Our proposed disclosure guidance has been prompted by our experience that, in some cases, inadequate disclosure has contributed to investors not understanding the risks when purchasing a hedge fund product.

## Responses to CP 147—Further consultation

- 5 We received seven submissions in response to CP 147. The submissions were generally supportive of our proposals, but raised some issues, as discussed below, which we have addressed in the attached draft regulatory guide.
- 6 We have also made a number of minor changes to the benchmarks and disclosure principles proposed in CP 147.
- 7 We are seeking further feedback on the changes we have made to our proposed disclosure guidance.

### What is a hedge fund?

- 8 Respondents generally agreed with the proposed characteristics in CP 147 for determining whether a scheme is a hedge fund. However, some submissions argued that these characteristics were too broad in scope and that schemes engaging in only one practice may be captured.
- 9 We acknowledge that a fund with only one characteristic may be caught and that whether a registered managed investment scheme is a hedge fund should be assessed in a holistic sense. We propose to retain the definition of a hedge fund (and fund of hedge funds) that we proposed in CP 147.
- 10 If a responsible entity is uncertain about whether a registered managed investment scheme is a hedge fund (or fund of hedge funds), we would expect the fund to disclose against the proposed benchmarks and apply the proposed disclosure principles to the extent relevant, or seek clarification from ASIC.

### Application of the benchmarks and disclosure principles to funds of hedge funds

- 11 Some submissions expressed concern that the proposed benchmarks and disclosure principles in CP 147 may be difficult to apply to funds of hedge funds. We have addressed this concern in our proposed disclosure guidance by noting where and how we would expect modified disclosure by funds of hedge funds.

### Interaction with the shorter PDS regime

- 12 Respondents generally believed that hedge funds should be excluded from the shorter PDS regime established by the Corporations Amendment Regulations 2010 (No. 5).
- 13 On 22 December 2011, the Minister for Financial Services and Superannuation, the Hon. Bill Shorten, announced that hedge funds would be excluded from the shorter PDS regime until these products could be fully considered in light of the policy intent of that regime.
- 14 This means that we would expect all hedge funds to disclose against the proposed benchmarks and apply the proposed disclosure principles, regardless of whether the fund meets the definition of a simple managed investment scheme.

## B Proposed disclosure guidance for hedge funds

### Key points

The attached draft regulatory guide sets out the specific features and risks of hedge funds that we think should be addressed in a PDS for these products.

The proposed benchmarks and disclosure principles are designed to improve disclosure for investors to enable more informed decisions about investing in products of this kind, and to make comparisons between the products and business models of different funds more straightforward.

In seeking to improve disclosure, we aim to ensure that investors have the information they need to make an informed investment decision. However, this should not be regarded as an indication that we consider these products to be suitable for all or most retail investors.

## Scope of our disclosure guidance

### Proposal

**B1** We propose that, for the purposes of our guidance:

- (a) a hedge fund is a registered managed investment scheme that is, or has been promoted as, or is generally regarded as, a hedge fund or a fund of hedge funds (see draft RG 000.4); and
- (b) in determining whether a particular registered managed investment scheme is a hedge fund, the following factors may be relevant (see draft RG 000.5):
  - (i) *Strategy*: The fund pursues complex strategies that aim to generate absolute returns, returns with low correlation to equity and bond indices, or a positive return in both rising and falling markets.
  - (ii) *Leverage*: The fund uses leverage to increase investment returns.
  - (iii) *Derivatives*: The fund uses derivatives to create complex investment strategies or for gearing purposes.
  - (iv) *Short selling*: The fund engages in short selling.
  - (v) *Complexity*: The fund has exposure to diverse risks and complex underlying investments.

**Your feedback**

- B1Q1 Do you agree with the proposed scope of our disclosure guidance?
- B1Q2 Should the disclosure guidance apply to any fund that manifests one or more of the characteristics identified in B1(b), irrespective of whether it is promoted or generally regarded as a hedge fund?
- B1Q3 Should the test at B1(a) of whether a fund is a hedge fund be simply another characteristic to be considered in deciding whether a fund is a hedge fund?
- B1Q4 Should the disclosure guidance apply to funds that only manifest one of the characteristics identified in B1(b), or should some features (e.g. use of leverage) be more decisive than others in the characterisation of hedge funds?
- B1Q5 Does our proposed approach provide a sufficient level of certainty? If not, how should 'hedge fund' be defined, and why?
- B1Q6 Should our disclosure guidance also apply to funds that do not, or do not intend to, engage in the strategies listed but that reserve the right to do so without notice to investors?

**Proposal**

- B2** We propose that, where a hedge fund has invested 25% or more of its assets in an underlying hedge fund or structured product, the proposed benchmarks and disclosure principles should be taken to apply to the underlying fund or structured product (see draft RG 000.7–RG 000.11).

**Your feedback**

- B2Q1 Do you agree with our treatment and characterisation of funds of hedge funds?
- B2Q2 Do you agree that, for the purposes of disclosure, it is appropriate to apply an investment threshold of 25% at the fund of hedge funds level? Should the threshold be higher or lower?
- B2Q3 Where a fund of funds invests in a variety of underlying funds, including hedge funds, should there be a threshold for the total level of investment in hedge funds that would qualify the fund of funds as a fund of hedge funds?

**Rationale**

- 15 We propose that our disclosure guidance would apply to hedge funds and funds of hedge funds, as defined in proposals B1 and B2.
- 16 Although there is no definition of a hedge fund in the *Corporations Act 2001* (Corporations Act), there are some characteristics that distinguish hedge funds from other managed investment schemes, such as the use of leverage, derivatives and short selling to seek a positive return for investors in both rising and falling markets. These characteristics and other features of hedge funds

17

mean that investors in these funds can be exposed to more diverse and complex risks than investors in funds pursuing more ‘vanilla’ investment strategies.

If a responsible entity is uncertain about whether a registered managed investment scheme is a hedge fund (or fund of hedge funds), we would expect the fund to disclose against the proposed benchmarks and apply the proposed disclosure principles to the extent relevant, or seek clarification from ASIC.

## Benchmarks and disclosure principles for hedge funds

### Proposal

- B3** We propose that responsible entities of hedge funds should address benchmarks in disclosures to retail investors, on an ‘if not, why not’ basis, on the following matters (as set out in the attached draft regulatory guide):
- (a) valuation and custody of assets (see Benchmark 1 at draft RG 000.38–RG 000.41); and
  - (b) periodic reporting (see Benchmark 2 at draft RG 000.42–RG 000.46).

#### *Your feedback*

**B3Q1** Have we identified the relevant benchmarks?

**B3Q2** Are there any other benchmarks we should include?

**B3Q3** Have we included anything that is not relevant?

### Proposal

- B4** We propose that responsible entities of hedge funds should provide information in disclosures to retail investors about the following matters (as set out in the disclosure principles in the attached draft regulatory guide):
- (a) investment strategy (see draft RG 000.47–RG 000.50);
  - (b) investment manager (see draft RG 000.51–RG 000.53);
  - (c) fund structure (see draft RG 000.54–RG 000.56);
  - (d) valuation, location and custody of assets (see draft RG 000.57–RG 000.59);
  - (e) liquidity (see draft RG 000.60–RG 000.62);
  - (f) leverage (see draft RG 000.63–RG 000.68);
  - (g) derivatives and structured products (see draft RG 000.69–RG 000.71);
  - (h) short selling (see draft RG 000.72–RG 000.74); and
  - (i) withdrawals (see draft RG 000.75–RG 000.77).

#### *Your feedback*

**B4Q1** Have we identified the relevant disclosure principles?

**B4Q2** Are there any other disclosure principles we should include?

**B4Q3** Have we included anything that is not relevant?

## Rationale

- 18 We propose that responsible entities of hedge funds should disclose to investors information on specific key features and risks of the fund. Our proposed guidance consists of a combination of disclosure principles and ‘if not, why not’ benchmarks. Each benchmark and disclosure principle identifies a key risk area that potential investors should understand before making a decision to invest. Failure to disclose against the benchmarks and apply the disclosure principles would result in an increased risk of ASIC issuing a stop order for the offer.
- 19 Where we have proposed an ‘if not, why not’ benchmark in relation to a particular risk or feature, the responsible entity should state in the PDS and other disclosures whether it meets the benchmark, and if not, why not.
- 20 This model of disclosure provides standards by which retail investors can assess financial products for which there are typically few such external benchmarks.
- 21 Where we have proposed a disclosure principle, this identifies a particular risk or feature of hedge funds that we consider a responsible entity should clearly and prominently address in the PDS. This disclosure will help retail investors to understand the significant benefits, risks and features of the fund.
- 22 We believe that the proposed benchmarks and disclosure principles address the key issues that we think should be:
- (a) highlighted in disclosure relating to hedge funds; and
  - (b) discussed in a manner that allows prospective retail investors to make an informed decision about whether to invest.

## C Regulatory and financial impact

- 23 In developing the proposals in this paper, we have carefully considered their regulatory and financial impact. On the information currently available to us, we think they will strike an appropriate balance between:
- (a) preventing the mis-selling of hedge funds to retail investors; and
  - (b) not unduly interfering with the marketing and sale of financial products.
- 24 Before settling on a final policy, we will comply with the Australian Government's regulatory impact analysis (RIA) requirements by:
- (a) considering all feasible options, including examining the likely impacts of the range of alternative options which could meet our policy objectives;
  - (b) if regulatory options are under consideration, notifying the Office of Best Practice Regulation (OBPR); and
  - (c) if our proposed option has more than minor or machinery impact on business or the not-for-profit sector, preparing a Regulation Impact Statement (RIS).
- 25 All RISs are submitted to the OBPR for approval before we make any final decision. Without an approved RIS, ASIC is unable to give relief or make any other form of regulation, including issuing a regulatory guide that contains regulation.
- 26 To ensure that we are in a position to properly complete any required RIS, we ask you to provide us with as much information as you can about our proposals or any alternative approaches, including:
- (a) the likely compliance costs;
  - (b) the likely effect on competition; and
  - (c) other impacts, costs and benefits.

See ‘The consultation process’ p. 4.

# Attachment: Draft regulatory guide



**ASIC**

Australian Securities & Investments Commission

## REGULATORY GUIDE 000

# Hedge funds: Improving disclosure

February 2012

### About this guide

This guide is for those involved in the issue and sale of hedge funds. It sets out our guidance for improved disclosure to investors to help them understand and assess these products.

In seeking to improve disclosure, ASIC aims to ensure that investors and their advisers have the information they need to make an informed investment decision. However, this should not be regarded as an indication that we consider these products to be suitable for all or most retail investors.

DRAFT

## About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

**Consultation papers:** seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

**Regulatory guides:** give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

**Information sheets:** provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

**Reports:** describe ASIC compliance or relief activity or the results of a research project.

## Document history

This draft regulatory guide was issued in February 2012 and is based on legislation and regulations as at the date of issue.

## Disclaimer

This guide does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

Examples in this guide are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

DRAFT

# Contents

<b>A</b>	<b>Overview .....</b>	<b>15</b>
	Who this guide applies to.....	15
	Improving disclosure for hedge funds.....	18
	Benchmarks and disclosure principles for hedge funds .....	20
	Form and method of disclosure .....	21
	Timing for implementing improved disclosure .....	22
<b>B</b>	<b>Benchmarks for hedge funds .....</b>	<b>23</b>
	Benchmark 1: Valuation and custody of assets.....	23
	Benchmark 2: Periodic reporting .....	24
<b>C</b>	<b>Disclosure principles for hedge funds .....</b>	<b>26</b>
	Disclosure Principle 1: Investment strategy.....	26
	Disclosure Principle 2: Investment manager .....	27
	Disclosure Principle 3: Fund structure.....	28
	Disclosure Principle 4: Valuation, location and custody of assets.....	29
	Disclosure Principle 5: Liquidity .....	30
	Disclosure Principle 6: Leverage .....	31
	Disclosure Principle 7: Derivatives and structured products .....	32
	Disclosure Principle 8: Short selling .....	32
	Disclosure Principle 9: Withdrawals .....	33
<b>D</b>	<b>Form and method of disclosure .....</b>	<b>34</b>
	How to disclose against the benchmarks and apply the disclosure principles .....	34
	Updating existing investors.....	35
	Up-front disclosure for new investors .....	36
	Content of a PDS.....	36
	Ongoing disclosure .....	38
	<b>Key terms .....</b>	<b>41</b>
	<b>Related information.....</b>	<b>42</b>

DRAFT

## A Overview

### Key points

Hedge funds can pose more diverse and complex risks for investors than traditional managed investment schemes. This is because of their diverse investment strategies, in many cases involving the use of leverage, and complex and offshore structures.

The benchmarks and disclosure principles in this draft guide set out the specific features and risks of hedge funds that we think should be addressed in a Product Disclosure Statement (PDS) for these products.

The benchmarks and disclosure principles are designed to improve disclosure so that investors can make more informed decisions about investing in products of this kind, and to make comparisons between the products and business models of different funds more straightforward.

In seeking to improve disclosure, we aim to ensure that investors have the information they need to make an informed investment decision. However, this should not be regarded as an indication that we consider these products to be suitable for all or most retail investors.

Disclosure against the benchmarks and disclosure principles should be:

- addressed up-front in the PDS; and
- updated in ongoing disclosure as material changes occur (e.g. in a supplementary PDS).

## Who this guide applies to

RG 000.1 This guide is for responsible entities of hedge funds, and those responsible for preparing a PDS for an offer of interests in a hedge fund.

Note: Section 1013A of the *Corporations Act 2001* (Corporations Act) sets out who is responsible for preparing a PDS in various circumstances.

RG 000.2 As a matter of best practice, we encourage other issuers to disclose against the benchmarks and apply the disclosure principles when providing information to investors in similar situations, such as offers of shares in investment companies pursuing investment strategies normally associated with hedge funds or offers to wholesale investors of interests in a hedge fund: see also RG 000.12–RG 000.14.

## What is a hedge fund?

- RG 000.3 Although there is no definition of a hedge fund in the Corporations Act, there are some characteristics that distinguish hedge funds from other managed investment schemes, such as the use of leverage, derivatives and short selling to seek a positive return for investors in both rising and falling markets. These characteristics and other features of hedge funds mean that investors in these funds can be exposed to more diverse and complex risks than investors in funds pursuing more ‘vanilla’ investment strategies.
- RG 000.4 For the purposes of this guide, a hedge fund is a registered managed investment scheme that is, or has been promoted as, or is generally regarded as, a hedge fund or a fund of hedge funds.
- RG 000.5 In determining whether a particular registered managed investment scheme is a hedge fund, the following factors may be relevant:
- (a) *Strategy*: The fund pursues complex strategies that aim to generate absolute returns, returns with low correlation to equity and bond indices, or a positive return in both rising and falling markets.
  - (b) *Leverage*: The fund uses leverage to increase investment returns.
  - (c) *Derivatives*: The fund uses derivatives to create complex investment strategies or for gearing purposes.
  - (d) *Short selling*: The fund engages in short selling.
  - (e) *Complexity*: The fund has exposure to diverse risks and complex underlying investments.
- RG 000.6 If a responsible entity is uncertain about whether a registered scheme is a hedge fund (or fund of hedge funds), we would expect the fund to disclose against the benchmarks and apply the disclosure principles in this guide to the extent relevant, or seek clarification from ASIC.

## Funds of hedge funds and intermediate investment vehicles

- RG 000.7 Many hedge funds gain indirect exposure to a range of investments in financial products by investing in intermediate vehicles, structured products (e.g. deferred purchase agreements), other funds (called ‘underlying funds’) or managed accounts which are managed by traders using hedge fund strategies. Hedge funds are called ‘funds of hedge funds’ when they invest in a number of hedge funds or managed accounts.
- RG 000.8 The benchmarks and disclosure principles in this guide cover a range of disclosures relating to the responsible entity, the individuals making the investment decisions, service providers, fund strategies and fund assets. Where a hedge fund has invested 25% or more of its assets in an underlying hedge fund or structured product, the benchmarks and disclosure principles in this guide should be taken to apply to the underlying fund or structured product. In these cases, responsible entities of funds of hedge funds should

DRAFT

disclose against the benchmarks and apply the disclosure principles for each such underlying fund and its investments, or each such structured product and the product's reference assets, unless otherwise indicated in the benchmarks and principles. These disclosures would be in addition to disclosures for the hedge fund operated by the responsible entity.

- RG 000.9 Responsible entities of funds of hedge funds should make the additional or varied disclosures relating to their whole portfolio, as specified in the benchmarks and disclosure principles as being appropriate for funds of hedge funds.
- RG 000.10 For the purposes of this guide, including for the 25% threshold in RG 000.8, where a hedge fund's assets are placed in a managed account, the responsible entity should treat the account manager as an underlying fund manager and the account as an underlying fund.
- RG 000.11 Where a hedge fund invests in a number of underlying hedge funds or managed accounts with common or related managers, each of those investments should be aggregated for the purposes of determining whether the 25% threshold in RG 000.8 is satisfied. If, when aggregated, the hedge fund's investments meet or exceed the 25% threshold, the responsible entity should disclose against the benchmarks and apply the disclosure principles for each such underlying fund or managed account.

## **Application to other products**

- RG 000.12 While the benchmarks and disclosure principles in this guide are primarily directed at PDSs for hedge funds, we consider that there may be other entities and circumstances that pose similar types of risks to investors. As a matter of best practice, we encourage issuers to disclose against the benchmarks and apply the disclosure principles when providing information to investors in similar situations, such as:
  - (a) similar offers to wholesale investors; and
  - (b) offers by investment companies that have some of the features of hedge funds.
- RG 000.13 If a scheme could be characterised as a hedge fund but also falls more specifically within a category of schemes covered by certain other ASIC disclosure guidance, we would expect the scheme to follow that other more specific disclosure guidance. This includes schemes that are subject to any of the following regulatory guides:
  - (a) Regulatory Guide 148 *Investor directed portfolio services* (RG 148) as an investor directed portfolio service (IDPS) or IDPS-like scheme;
  - (b) Regulatory Guide 45 *Mortgage schemes: Improving disclosure for retail investors* (RG 45);
  - (c) Regulatory Guide 46 *Unlisted property schemes: Improving disclosure for retail investors* (RG 46);

- (d) Regulatory Guide 231 *Infrastructure entities: Improving disclosure for retail investors* (RG 231); or
- (e) Regulatory Guide 232 *Agribusiness managed investment schemes: Improving disclosure for retail investors* (RG 232).

RG 000.14 We also encourage issuers to consider any applicable industry standards.

### **Interaction with the shorter PDS regime**

- RG 000.15 Some hedge funds may fall under the new shorter PDS regime for simple managed investment schemes established by the Corporations Amendment Regulations 2010 (No. 5). This is because the definition of simple managed investment schemes for the purposes of this regime is partly based on whether the fund can realise 80% of its assets at market value within 10 days.
- RG 000.16 A hedge fund may fall within the definition of a simple managed investment scheme despite the complexity of its strategy and investment structure, or the nature of its investment exposures or activities (e.g. long/short equity funds that invest in ASX 200 stocks and managed futures funds that invest in exchange-traded futures contracts).
- RG 000.17 On 22 December 2011, the Government announced that hedge funds would be excluded from the shorter PDS regime until these products could be fully considered in light of the policy intent of that regime.
- RG 000.18 This means that we expect all hedge funds to disclose against the benchmarks and apply the disclosure principles in this guide, regardless of whether the fund meets the definition of a simple managed investment scheme.

## **Improving disclosure for hedge funds**

### **The role of disclosure**

- RG 000.19 The disclosure framework in the Corporations Act requires the responsible entity of a hedge fund to:
- (a) disclose up-front to retail investors all the information they reasonably need to know to make a decision about whether or not to acquire the product;
  - (b) provide ongoing disclosure about material matters to help retail investors monitor whether their expectations are being met; and
  - (c) provide periodic disclosure.
- RG 000.20 Our disclosure guidance is not designed to stop or discourage retail investors from taking investment risks, but to help them and their advisers understand the risks involved in any particular investment or type of investment. This

enables them to make a more informed decision about whether the potential reward (the return on their investment) warrants the level of risk involved. This approach should also lead to comparable disclosure by responsible entities of hedge funds, helping investors to compare investments in this sector.

RG 000.21 Given the risks for retail investors associated with investing in hedge funds, and that many rely on disclosure material to inform their decisions to invest, we think it is necessary to ensure that disclosure provides retail investors with the information they need to make an informed decision about whether or not to invest.

### **The need for better disclosure to investors**

RG 000.22 Our guidance has been prompted by our experience that, in some cases, inadequate disclosure has contributed to investors not understanding the risks when purchasing a hedge fund product.

RG 000.23 Hedge funds have a different risk profile (including counterparty and liquidity risk) to other schemes. Responsible entities of hedge funds and their managers may:

- (a) invest in many types of financial products across diverse markets and in non-mainstream and often less liquid asset classes;
- (b) use a wider variety of complex investment techniques and more complex investment structures than traditional funds; and
- (c) borrow money to leverage the funds' investments or invest in assets with embedded leverage, which amplifies the prospects of both significant positive returns and significant losses.

Each hedge fund is different, so the PDS is a key mechanism for making sure that investors understand the investments and strategies the investment manager will be using.

RG 000.24 Inadequate disclosure occurs when the information required to be disclosed under the Corporations Act:

- (a) is not included in the PDS; or
- (b) is included in the PDS, but is not clear, concise and effective (e.g. the information is presented in such a dense and complex way that investors are unable to understand the true nature of the investment). This problem can be exacerbated if advertising and other sales practices do not highlight risks and thus give a misleading impression of the product.

## Benchmarks and disclosure principles for hedge funds

- RG 000.25 We have identified the following benchmarks and disclosure principles, which address the key issues that we think should be:
- (a) highlighted in PDS disclosure relating to hedge funds; and
  - (b) discussed in a manner that allows prospective retail investors to make an informed decision about whether to invest.

**Table 1: Summary of benchmarks for hedge funds**

Benchmark	Description
<b>1 Valuation and custody of assets</b>	This benchmark addresses whether valuations of the hedge fund's assets are provided by independent third party administrators, and whether custodians are unrelated to the responsible entity or investment manager of the hedge fund: see also Disclosure Principle 4.
<b>2 Periodic reporting</b>	This benchmark addresses whether the responsible entity of the hedge fund will provide periodic disclosure of the current funds under management (FUM) of the fund and the investment returns as at the end of the period.

**Table 2: Summary of disclosure principles for hedge funds**

Disclosure principle	Description
<b>1 Investment strategy</b>	This disclosure principle is intended to ensure that investors are made aware of the details of the investment strategy for the fund, including the type of strategy, how it works in practice and how risks are managed.
<b>2 Investment manager</b>	This disclosure principle is intended to ensure that investors have the necessary information about the people responsible for managing the investment, such as their qualifications and relevant commercial experience, and the proportion of their time devoted to the hedge fund.
<b>3 Fund structure</b>	This disclosure principle is intended to ensure that the responsible entity of the hedge fund explains the investment structures involved, the relationships between entities in the structure, the jurisdictions involved (if these involve parties offshore), the due diligence performed on underlying funds, and the related party relationships within the structure.
<b>4 Valuation, location and custody of assets</b>	This disclosure principle supplements Benchmark 1 to ensure that the responsible entity of the hedge fund discloses the types of assets held, where they are located, how they are valued and the custodial arrangements.
<b>5 Liquidity</b>	This disclosure principle is intended to ensure that, if at least 20% of the hedge fund's assets cannot be sold at market value within 10 days, investors are made aware of the nature and risks of the illiquid classes of assets.
<b>6 Leverage</b>	This disclosure principle is intended to ensure that investors are made aware of the anticipated level of leverage of the fund (including leverage embedded in the assets of the fund).

DRAFT

Disclosure principle	Description
<b>7 Derivatives and structured products</b>	This disclosure principle is intended to ensure that investors are made aware of the purpose and types of derivatives and structured products used by the hedge fund, and the associated risks.
<b>8 Short selling</b>	This disclosure principle is intended to ensure that investors are made aware of how short selling may be used as part of the investment strategy, and of the associated risks and costs of short selling.
<b>9 Withdrawals</b>	This disclosure principle is intended to ensure that investors are made aware of the circumstances in which the responsible entity of the hedge fund allows withdrawals and how this might change.

## Form and method of disclosure

- RG 000.26 Our disclosure model for hedge funds consists of a combination of disclosure principles and ‘if not, why not’ benchmarks. Each benchmark and disclosure principle identifies a key risk area that potential investors should understand before making a decision to invest. Failure to disclose against the benchmarks and apply the disclosure principles will result in an increased risk of a PDS not making the disclosure required by the Corporations Act, or not being ‘clear, concise and effective’, and ASIC issuing a stop order for the offer or taking other action if we consider investors have been misled or deceived.
- RG 000.27 Where we have provided guidance on an ‘if not, why not’ benchmark in relation to a particular risk or feature, a responsible entity should state in the PDS and other disclosures whether it meets the benchmark and, if not, why not.
- RG 000.28 This model of disclosure provides standards by which retail investors can assess financial products for which there are typically few such external benchmarks.
- Note: If a responsible entity cannot meet all aspects of a benchmark, it should state that it does not meet the benchmark and clearly explain which aspects it meets and, for those it does not meet, explain why not and how it deals with the associated risks in another way.
- RG 000.29 Failing to meet one or more of the benchmarks does not mean that a product provided by a particular issuer necessarily represents a poor investment. However, the responsible entity will need to explain what alternative measures it has in place to mitigate the concern underlying the benchmark.
- RG 000.30 Where we have provided guidance on a disclosure principle, this identifies a particular feature or risk of hedge funds that we consider a responsible entity should clearly and prominently address in the PDS. This disclosure will help retail investors to understand the significant benefits, risks and features of the fund.
- RG 000.31 Where a disclosure principle is not relevant (e.g. the particular feature does not apply to a fund or the fund does not engage in the particular activity), the PDS need not apply that principle.

DRAFT

- RG 000.32 The benchmark and disclosure principle information should be:
- (a) addressed up-front in the PDS;
  - (b) updated in ongoing disclosure as material changes occur (e.g. in a supplementary PDS); and
  - (c) supported in, and not undermined by, advertising material.
- RG 000.33 In the interests of ensuring that existing investors are well informed, a responsible entity may also choose to provide regular reports on this information in other materials (e.g. monthly or quarterly updates), although providing updates in this form will not relieve the responsible entity from its disclosure obligations if any material changes occur. A responsible entity may, when updating certain information that is not materially adverse from the viewpoint of an investor, rely on Class Order [CO 03/237] *Updated information in product disclosure statements* to provide updates on a website if the PDS states that this may occur.
- RG 000.34 We believe that our approach balances:
- (a) the need to improve disclosure to allow investors to make better informed decisions; and
  - (b) the benefit of allowing responsible entities of hedge funds to pursue diverse investment strategies and employ complex structures.
- Note: The need to strike an appropriate balance between protecting investors' interests and allowing markets to operate freely is part of ASIC's mandate under the *Australian Securities and Investments Commission Act 2001* (ASIC Act).
- RG 000.35 Our experience indicates that investors need better quality and relevant disclosure, presented in a way best suited to investor understanding.

## Timing for implementing improved disclosure

- RG 000.36 Responsible entities of hedge funds should disclose against the benchmarks and apply the disclosure principles in any PDS dated on or after 1 March 2013. We also expect responsible entities to provide the benchmark and disclosure principle information in their ongoing disclosure from that date: see Section D.
- RG 000.37 By no later than 1 March 2013, if an existing PDS is still in use, responsible entities should:
- (a) include the benchmark and disclosure principle information on a website referred to in the PDS (if the omission of this benchmark and disclosure principle information from the PDS is not materially adverse); or
  - (b) update the PDS by a new or supplementary PDS so that it includes the benchmark and disclosure principle information.

DRAFT

## B Benchmarks for hedge funds

### Key points

Responsible entities of hedge funds should address benchmarks on the following matters in disclosures to retail investors:

- valuation and custody of assets (see RG 000.38–RG 000.41); and
- periodic reporting (see RG 000.42–RG 000.46).

This information should be disclosed clearly and prominently in the PDS and ongoing disclosure for the hedge fund: see Section D.

### Benchmark 1: Valuation and custody of assets

- RG 000.38 The responsible entity has and implements a policy that requires:
- (a) valuations of the hedge fund's assets that are not exchange traded to be provided by independent third party administrators; and
  - (b) all custodians involved in the fund structure (including custodians of any underlying funds) to be unrelated to the responsible entity or investment manager of the hedge fund.

### Explanation

- RG 000.39 This benchmark, with Disclosure Principle 4, ensures that hedge funds disclose the types of assets held, where they are located, how they are valued and their custodial arrangements. The use of independent fund administrators and custodians has become more widespread in recent years, driven largely by investor concerns about the potential for manager misconduct when these functions are performed in-house. While there is often justification for these activities to be performed by responsible entities, we consider it appropriate for a responsible entity that elects not to use independent service providers to perform these functions to advise investors of this fact and tell them why.
- RG 000.40 If the responsible entity does not meet this benchmark, it should explain why not and how it addresses the risks of the lack of independence in valuations and related party conflicts of interest: see also Disclosure Principle 4.
- RG 000.41 Responsible entities of funds of hedge funds should disclose their policy on the use of independent fund administrators by managers of underlying funds.

## Benchmark 2: Periodic reporting

RG 000.42 The responsible entity has and implements a policy to provide periodic reports on certain key information, as set out in Table 3.

**Table 3: Periodic reporting of key information**

Annual (or more frequent) reporting	<p>The responsible entity has and implements a policy to report on the following information as soon as practicable after the relevant period end:</p> <ul style="list-style-type: none"> <li>• the current funds under management (FUM);</li> <li>• the actual allocation to each asset type (see RG 000.57(b));</li> <li>• the liquidity profile of the assets as at the end of the period—the representation of asset liquidity (the time required to sell an asset at its market value) in a graphical form that allows easy comparison with the maturity profile of the leverage;</li> <li>• the maturity profile of the leverage as at the end of the period—the representation of maturities in a graphical form that allows easy comparison with the liquidity profile of the assets;</li> <li>• the leverage ratio (including leverage embedded in the assets of the fund, other than listed equities and bonds) as at the end of the period;</li> <li>• the undrawn amount of loan facilities as at the end of the period;</li> <li>• the derivative and structured product over-the-counter (OTC) counterparties engaged (including capital protection providers);</li> <li>• the investment returns over at least a five-year period (or, if the hedge fund has not been operating for five years, the returns since its inception); and</li> <li>• the key service providers if they have changed since the latest report given to investors (see RG 000.54(b)).</li> </ul>
Ongoing availability	The latest report, which addresses the above matters, is available on the hedge fund's website.
Monthly updates	<p>The following information is available on the hedge fund's website and is disclosed monthly or, if less often, at least on each date investors are able to redeem their investments:</p> <ul style="list-style-type: none"> <li>• the current FUM, the undrawn amount of loan facilities as at the end of the period, and the key service providers if they have changed since the last report given to investors; and</li> <li>• for each of the following matters since the last report on those matters: <ul style="list-style-type: none"> <li>– the pre-tax return on the fund's assets on both a before and after fees and costs basis;</li> <li>– any material change in the fund's risk profile;</li> <li>– any material change in the fund's strategy; and</li> <li>– any change in the individuals playing a key role in investment decisions for the fund.</li> </ul> </li> </ul>

## Explanation

RG 000.43 The Corporations Act requires a hedge fund to give investors a periodic statement at least annually. However, we understand that current market practice is to provide investors with more frequent reports and we encourage

responsible entities to do this. This benchmark sets out the matters that we consider investors are likely to have an interest in knowing at least annually.

- RG 000.44 We consider that investors are also likely to want to monitor basic performance information on their hedge fund investments more often than annually. The benchmark is designed to ensure that investors receive timely, basic fund performance information to enable them to closely monitor the ongoing performance of their hedge fund investments and decide on an informed basis whether to stay in or exit their investments.
- RG 000.45 If the responsible entity does not meet this benchmark, it should explain why not and state its policy on what information will be provided, how and when.
- RG 000.46 For funds of hedge funds, the responsible entity should disclose against this benchmark in relation to the underlying funds.

## C Disclosure principles for hedge funds

### Key points

Responsible entities of hedge funds should provide information about the following matters in disclosures to retail investors:

- investment strategy (see RG 000.47–RG 000.50);
- investment manager (see RG 000.51–RG 000.53);
- fund structure (see RG 000.54–RG 000.56);
- valuation, location and custody of assets (see RG 000.57–RG 000.59);
- liquidity (see RG 000.60–RG 000.62);
- leverage (see RG 000.63–RG 000.68);
- derivatives and structured products (see RG 000.69–RG 000.71);
- short selling (see RG 000.72–RG 000.74); and
- withdrawals (see RG 000.75–RG 000.77).

This information should be disclosed clearly and prominently in the PDS and ongoing disclosure for the hedge fund: see Section D.

### **Disclosure Principle 1: Investment strategy**

RG 000.47 The responsible entity should disclose the following information:

- (a) a description of the fund’s investment strategy, including:
  - (i) the typical asset classes to be invested in;
  - (ii) the typical location and currency denomination of the assets; and
  - (iii) the role of leverage, derivatives and short selling;

Note: For other related disclosures, see leverage, derivatives and structured products, and short selling.
- (b) an explanation of how the strategy will produce investment returns;
- (c) any key dependencies or assumptions underpinning the strategy’s ability to produce investment returns (e.g. market conditions or interest rates);
- (d) what the diversification guidelines or limits are;
- (e) any specific risks associated with the relevant investment strategy;
- (f) disclosure of the key aspects of the fund’s risk management strategy; and
- (g) if and how the investment strategy can change and what notification would be provided to investors.

DRAFT

## Explanation

- RG 000.48 A clear and concise explanation of the fund's investment strategy is a key requirement to enable an investor to make an informed decision about whether to invest in the fund. This disclosure principle is intended to ensure that investors are made aware of the details of the investment strategy for the fund, including the type of strategy, how it works in practice, and how risks are managed. It should provide sufficient detail for an investor to understand the particular risks involved, and give context to other disclosures—for example, to assess the competency of key investment decision makers to execute the investment strategy.
- RG 000.49 For funds of hedge funds, the responsible entity should apply this disclosure principle as though the reference to 'asset' at RG 000.47(a)(i) reads 'underlying fund' and need not provide the information in RG 000.47(a)(ii) in addition to the disclosures set out at RG 000.57.
- RG 000.50 Responsible entities of funds of hedge funds should also provide sufficient information to explain the strategy for selecting which underlying funds they will invest in. Further, for each material investment in an underlying fund, the responsible entity should explain why that particular fund was selected and how it fits with the investment strategy.

## Disclosure Principle 2: Investment manager

- RG 000.51 The responsible entity should disclose a description of the following:
- (a) the identity of, and information on any relevant significant adverse regulatory findings against, any investment manager appointed by the responsible entity of the hedge fund;
  - (b) the identities, relevant qualifications and commercial experience (including information on any relevant significant adverse regulatory findings against) of the individuals playing a key role in investment decisions and the proportion of their time each will devote to executing the fund's investment strategy;
  - (c) if any of the assets are not managed by the responsible entity, any unusual or materially onerous (from an investor's perspective) terms in the agreement under which any investment manager is appointed and the scope of this appointment; and
  - (d) the circumstances in which the responsible entity is entitled to terminate the investment manager's appointment and on what terms (including any payments).

DRAFT

## Explanation

- RG 000.52 This disclosure principle is intended to ensure that investors have the necessary information about the people responsible for managing the investment, as well as the relationships between the responsible entity and any investment manager.
- RG 000.53 The higher level of fees paid to investment managers of hedge funds, the complexities of the strategies involved and the prospect held out of exceeding equity and/or bond industry benchmarks, make the experience and qualifications of the key investment decision makers, and the time that they devote to executing the investment strategy, critical information. The PDS should relate their experience and qualifications to the fund's strategy.

## Disclosure Principle 3: Fund structure

- RG 000.54 The responsible entity should disclose the following information:
- (a) the fund's investment structure—that is, the key entities involved (e.g. companies, schemes and limited partnerships), their relationship to each other and their roles, together with a diagram showing the flow of investment money through the structure;
  - (b) the identities of the key service providers and intermediaries (e.g. prime broker, custodian, administrator and auditor), where applicable;
  - (c) how the responsible entity ensures that its key service providers will comply with their service agreement obligations;
  - (d) any related party relationships within the structure, including any related party relationships with the investment manager;
  - (e) the existence and nature of material arrangements in connection with the hedge fund that are not on arm's length terms (see Regulatory Guide 76 *Related party transactions* (RG 76));
  - (f) for funds of hedge funds, the due diligence process performed on underlying funds and their key service providers;
  - (g) where a fund invests in underlying funds or structured products, or invests through managed accounts, the fees and costs paid at each layer together with a worked example of the accumulated impact of these fees and costs over a year. This should be based on a reasonable estimate of the likely or anticipated fees and costs, and a reasonable and disclosed assessment of investment performance, as a proportion of the amount invested (e.g. for each \$1 invested by an investor, the accumulated impact of the direct and indirect fees and costs will be x cents);
  - (h) the jurisdictions involved; and
  - (i) the risks of the structure, including any risks associated with holding assets overseas or, for funds of hedge funds, with investing in underlying funds overseas.

DRAFT

## Explanation

- RG 000.55 This disclosure principle is intended to ensure that the fund explains the investment structures involved, the relationships between entities in the structure, the jurisdictions involved, the due diligence performed on underlying funds, and the related party relationships within the structure.
- RG 000.56 For funds of hedge funds, the disclosures at RG 000.54(c) and RG 000.54(e) should only be made for the fund of hedge funds, not for the underlying funds.

## Disclosure Principle 4: Valuation, location and custody of assets

- RG 000.57 The responsible entity should disclose the following information:
- (a) the key aspects of the valuation policy;
  - (b) the types of assets and the allocation range for each asset type, using the following asset types (including the assets of underlying funds):
    - (i) Australian listed equities;
    - (ii) Australian unlisted equities;
    - (iii) international listed equities;
    - (iv) international unlisted equities;
    - (v) Australian government bonds;
    - (vi) Australian corporate bonds;
    - (vii) international government bonds;
    - (viii) international corporate bonds;
    - (ix) structured products;
    - (x) real property;
    - (xi) infrastructure;
    - (xii) exchange-traded derivatives;
    - (xiii) over-the-counter (OTC) derivatives;
    - (xiv) cash equivalent investments; and
    - (xv) other (provide details);
  - (c) any policy about the geographic location of the asset;
  - (d) the geographic location of any material asset; and
  - (e) the custodial arrangements, including details of the roles provided by custodians.

DRAFT

## Explanation

- RG 000.58 This disclosure principle supplements Benchmark 1 to ensure that the responsible entity of the hedge fund discloses the types of assets held, where they are located, how they are valued and the custodial arrangements.
- RG 000.59 For funds of hedge funds, the responsible entity should disclose:
- (a) its valuation policy;
  - (b) the types of underlying funds (including their strategies);
  - (c) the allocation ranges;
  - (d) any policies on the geographic location of underlying funds, their managers or the geographic focus of their investing;
  - (e) the custodial arrangements for the fund of hedge fund's assets and the roles of custody providers; and
  - (f) any policies to be applied in relation to the custodial arrangements of underlying funds.

## Disclosure Principle 5: Liquidity

- RG 000.60 A hedge fund is liquid if it invests at least 80% of its assets under one or more arrangements by which the responsible entity can reasonably expect to realise the investment, at the market value of the assets, within 10 days. If the hedge fund is not liquid, the responsible entity should disclose the following information:
- (a) a description of any illiquid asset class that has a value greater than 10% of the fund's net asset value; and
  - (b) the key aspects of the liquidity management policy.

## Explanation

- RG 000.61 This disclosure principle is intended to ensure that, if at least 80% of the fund's assets cannot be sold at market value within 10 days, investors are made aware of the nature and risks of the illiquid classes of assets. Disclosure about liquidity becomes even more important under stressed market conditions.
- RG 000.62 In addition, responsible entities of funds of hedge funds should describe their investment policy in relation to the liquidity of underlying funds, and explain any risks posed to the fund of hedge fund's liquidity by the nature of these investments and how that risk will be managed.

DRAFT

## Disclosure Principle 6: Leverage

- RG 000.63 The responsible entity should disclose the following information:
- (a) the sources of leverage, including the type, the amount and the providers of the leverage;
  - (b) whether any assets are used as collateral, and the extent to which they are otherwise encumbered or exposed to set-off rights or other legitimate claims by third parties in the event of the insolvency of the responsible entity, a service or credit provider, or a counterparty;
  - (c) the maximum anticipated or allowed level of leverage (including leverage embedded in the assets of the fund) as a multiple of the net asset value of an investor's capital in the fund (e.g. for every \$1 of the fund's net asset value, the fund is leveraged \$x); and
- Note: The maximum anticipated or allowed level of leverage may be disclosed alongside the anticipated or typical level of leverage.
- (d) a worked example showing the impact of leverage on investment returns and losses, assuming the anticipated level of leverage (including leverage embedded in the assets of the fund).

### Explanation

- RG 000.64 Leverage is the use of financial products (such as derivatives) or debt (such as a margin facility) to amplify the exposure of capital to an investment. This disclosure principle is intended to ensure that investors are made aware of the maximum anticipated level of leverage of the fund (including leverage embedded in the assets of the fund). Information about the use and extent of leverage is critical because it amplifies both positive returns and losses.
- RG 000.65 We expect that leverage will be disclosed as a gross figure (total long positions plus total short positions) even if net leverage (total long positions minus total short positions) is also disclosed. We consider that a net figure alone may not provide sufficient information to investors because a leveraged position may not be offset by an opposite position if the positions do not correlate totally (e.g. the liquidity or maturity profiles may be different). Further, counterparty risk will often not be offset.
- RG 000.66 We expect the responsible entity to disclose either:
- (a) the name of the actual provider of the leverage; or
  - (b) the class or type of leverage provider (e.g. whether they are prudentially regulated, a local branch of a global investment bank or an unrated related party).
- RG 000.67 We acknowledge that when preparing a PDS, particularly for a new fund, it may be difficult for the responsible entity to know the anticipated level of

DRAFT

leverage. We expect that, if the anticipated level of leverage is disclosed as a range, the range will be small enough to be meaningful to investors.

- RG 000.68 In addition, the responsible entity of a fund of hedge funds should disclose its investment policy in relation to acceptable types of leverage used by underlying funds and any limits on leverage the fund of hedge funds will set (for each fund or across its portfolio).

## **Disclosure Principle 7: Derivatives and structured products**

- RG 000.69 The responsible entity should disclose the following information:
- (a) the purpose and rationale for the use of derivatives or structured products (e.g. investment, hedging, leverage and liquidity), including how they form part of the hedge fund's investment strategy;
  - (b) the types of derivative or structured product used or planned to be used;
  - (c) the criteria for engaging derivative and structured product counterparties (including principal protection providers);
  - (d) the key risks to the hedge fund associated with the collateral requirements of the derivative or structured product counterparties; and
  - (e) whether the derivatives or structured products are OTC or exchange-traded.

### **Explanation**

- RG 000.70 This disclosure principle is intended to ensure that investors are made aware of the purpose and types of derivatives and structured products used by the fund, and the associated risks.
- RG 000.71 In addition, the responsible entity of a fund of hedge funds should disclose its investment policy in relation to approved types of derivatives used by underlying funds and any limits on exposure to derivatives the fund of hedge funds will set (for each fund or across its portfolio).

## **Disclosure Principle 8: Short selling**

- RG 000.72 If a hedge fund intends or is likely to engage in short selling, the responsible entity should disclose the following information:
- (a) the purpose and rationale for short selling, including how short selling forms part of the hedge fund's investment strategy;
  - (b) the risks associated with short selling; and
  - (c) how these risks will be managed.

## Explanation

- RG 000.73 This disclosure principle is intended to ensure that investors are made aware of how short selling may be used as part of the investment strategy, and of the associated risks and costs of short selling. We encourage responsible entities to provide an example showing the potential gains and losses from short selling.
- RG 000.74 In addition to the information in RG 000.72, a responsible entity should disclose its investment policy on investing in underlying funds that may engage in short selling, and disclose the level of short selling permitted (if any) in each underlying fund and across its portfolio. If a fund of hedge funds may invest in underlying funds that may sell short, the responsible entity should explain the risks of short selling.

## Disclosure Principle 9: Withdrawals

- RG 000.75 The responsible entity should disclose the following information:
- (a) any significant risk factors or limitations that may affect the ability of investors to withdraw from the hedge fund, including any gating restrictions that may be imposed or the requirement for a statutory withdrawal offer if the hedge fund is not liquid;
  - (b) how investors can exercise their withdrawal rights, including any conditions on exercise;
  - (c) if withdrawal is to be funded from an external liquid facility, the material terms of this facility, including any rights the external liquid facility provider has to suspend or cancel the facility; and
  - (d) how investors will be notified of any material changes to their withdrawal rights (e.g. if withdrawal rights are to be suspended).

## Explanation

- RG 000.76 This disclosure principle ensures that investors are made aware of the circumstances in which the hedge fund allows withdrawals and how these might change.
- RG 000.77 Responsible entities of funds of hedge funds with investments in underlying funds, managed accounts or structured products need not disclose this information for those underlying investments.

DRAFT

## D Form and method of disclosure

### Key points

Responsible entities of hedge funds should disclose against the benchmarks on an 'if not, why not' basis and apply the disclosure principles in meeting their disclosure obligations to investors.

This applies to any PDS dated on or after 1 March 2013 and to ongoing disclosure from that date. Existing PDSs still in use should be supplemented or updated to reflect the improved disclosure.

### How to disclose against the benchmarks and apply the disclosure principles

- RG 000.78 We expect PDSs for hedge funds to disclose against the benchmarks and apply the disclosure principles. Table 4 explains how we expect responsible entities of hedge funds to provide this information.
- RG 000.79 Our view is that the inherent risks for investors in hedge funds mean that information about the risks addressed by the benchmarks and disclosure principles is required both in the PDS and in ongoing disclosure.
- RG 000.80 We expect that providing the benchmark and disclosure principle information will help responsible entities to produce PDSs that are better focused on the issues that matter to retail investors, and that are more clear, concise and effective.

**Table 4: Disclosing against the benchmarks and applying the disclosure principles**

<b>Benchmarks</b>	<p>Responsible entities will need to disclose against each of the benchmarks. We encourage this information to be prominently disclosed in the first few pages of any PDS.</p> <p>If responsible entities meet these benchmarks, they should state this.</p> <p>If responsible entities do not meet a benchmark, they should explain why not, and explain any additional risks that this may pose for the investor. If a responsible entity has alternative systems and controls in place to deal with the issues underlying the benchmark, it should explain this.</p> <p>Note: If a responsible entity cannot meet all aspects of a benchmark, it should state that it does not meet the benchmark and clearly explain which aspects it meets and, for those it does not meet, explain why not and how it deals with the associated risks in another way.</p>
<b>Disclosure principles</b>	<p>We expect that responsible entities should disclose the information addressed by the disclosure principles in all but exceptional circumstances.</p> <p>If the responsible entity is unable to provide the information—for example, in circumstances where contracts are yet to be entered into—the PDS should disclose the reasons why the information has not been provided and outline how and when investors will be provided with the information.</p> <p>Responsible entities should include a summary of the information identified in the disclosure principles in the first few pages of the PDS, and also provide references to where further information on the disclosure principles can be found in the body of the PDS.</p>

## Timing for implementing the benchmarks and disclosure principles: New and in-use PDSs

RG 000.81 A responsible entity that has existing investors and new offers of interests under a current PDS should disclose against the benchmarks and apply the disclosure principles: see Table 5. This is based on our view that the inherent risks for investors in hedge funds mean that information about these risks is required in both up-front and ongoing disclosure.

**Table 5: Implementing the benchmarks and disclosure principles**

<b>Updating existing investors</b>	By 1 March 2013, a responsible entity of a hedge fund should disclose against the benchmarks and apply the disclosure principles in updated disclosure and bring it directly to the attention of existing investors.
<b>Up-front disclosure for new investors</b>	All new PDSs issued on or after 1 March 2013 should disclose against the benchmarks and apply the disclosure principles.  If there are material changes to the benchmark or disclosure principle information while the PDS is current, the responsible entity will generally need to issue a new or supplementary PDS. The responsible entity should also communicate the information to existing investors who will not receive the PDS.
<b>Ongoing disclosure</b>	If there are material changes to the benchmark or disclosure principle information, the responsible entity should deal with this in ongoing disclosure. We encourage responsible entities to communicate this information to investors as soon as practicable.  In the interests of ensuring that existing investors are well informed, a responsible entity may also choose to provide regular updates on its disclosure in other materials (e.g. monthly or quarterly updates).

## Updating existing investors

- RG 000.82 We expect responsible entities to provide existing investors with updated disclosure addressing each of the benchmarks in Section B and applying each of the disclosure principles in Section C by 1 March 2013.
- RG 000.83 We consider that a responsible entity should use a dedicated page on its website to provide regular updates to investors about material changes to this information. We think this is the easiest and most practical way to keep investors up-to-date.
- RG 000.84 Good website disclosure can be an important resource for investors. We think good website disclosure has the following features:
- (a) all material information is included on the website;
  - (b) an investor can find material information easily and determine its significance for them;
  - (c) any new material information is included on the website as soon as practicable and flagged as 'new'; and

- (d) information is kept on the website for as long as it is relevant, and appropriate records are kept.

Note: Alternative or supplementary means of updating existing investors might be used to produce a regular (e.g. quarterly) report and send it to investors, or to issue a supplementary PDS and send a copy to existing investors, or publish it on the website and notify investors that it is available and how to access it.

## Up-front disclosure for new investors

- RG 000.85 All new PDSs issued to retail investors on or after 1 March 2013 should disclose against the benchmarks in Section B and apply the disclosure principles in Section C.

## Content of a PDS

- RG 000.86 The Corporations Act requires disclosure in the form of a PDS for an issue of interests in a hedge fund to retail investors. The PDS must:
- (a) make specific disclosures, including information about any significant risks associated with holding the product (s1013D); and
  - (b) include all other information that might reasonably be expected to have a material influence on the decision of a reasonable person whether to invest in the hedge fund, when investing as a retail investor (s1013E).

Note: We have issued policy guidance in Regulatory Guide 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)* (RG 168) on preparing a PDS that complies with the requirements in the Corporations Act. It sets out good disclosure principles and explains how we will monitor the use of PDSs and enforce the PDS requirements.

- RG 000.87 Our benchmarks and disclosure principles relate to matters that, in any event, should be disclosed under s1013D–1013E because they are all matters that might reasonably be expected to have a material influence on the decision of a reasonable person whether to invest in a product, when investing as a retail investor.

Note: The benchmarks and disclosure principles in this guide do not attempt to specify all the information that is required to be included in a PDS by the Corporations Act.

## The role of up-front disclosure

- RG 000.88 We encourage the responsible entity of a hedge fund to provide the benchmark and disclosure principle information within the first few pages of any PDS.
- RG 000.89 We will consider exercising our stop order powers under s1020E if we consider there is material non-disclosure or misleading disclosure of these matters. We believe that disclosing against the benchmarks and applying the disclosure principles up-front in a PDS promotes compliance with the

requirement that PDSs should be worded in a clear, concise and effective manner by encouraging comparability and uniformity of financial measures and highlighting issues that ASIC and industry experts consider crucial to making an investment decision.

### **Clear, concise and effective disclosure**

- RG 000.90 PDSs must be worded and presented in a clear, concise and effective manner: s1013C(3). A PDS should, therefore, include clear and prominent disclosure of the key features and risks of the investment. For hedge funds, this *includes* the benchmark and disclosure principle information.
- RG 000.91 To ensure the information is prominently disclosed, we consider that responsible entities should set out the benchmark and disclosure principle information in the first few pages of the PDS. This should be presented in as clear a manner as possible (e.g. in a table).
- RG 000.92 Where the benchmark and disclosure principle information is too lengthy to be included in full, the first few pages of the PDS should provide a summary of the information with a clear cross-reference to more detailed disclosure. This could include a well-referenced table that gives investors a brief introduction to the key information and a reference to where the information is further explained.

### **Updating PDSs**

- RG 000.93 If there are material changes to the benchmark or disclosure principle information provided by a responsible entity, the responsible entity with a current offer open will need to provide a new or supplementary PDS if the new information would be materially adverse to the reasonable investor.
- RG 000.94 We consider that it is good practice to also make the information in a new or supplementary PDS available to existing investors (e.g. in a regular investor update or on the website).
- RG 000.95 Where the updated information is not materially adverse, responsible entities may be able to rely on [CO 03/237] to provide updated benchmark and disclosure principle information on a website, subject to various conditions including:
- (a) the PDS must have included a statement that non-materially adverse information may be updated by a website and that a hard copy of any updated information will be given to a person without charge on request;
  - (b) the updated information is easily accessible to investors; and
  - (c) the PDS was up-to-date at the time it was prepared.

Note: See [CO 03/237] for all applicable conditions that must be fulfilled.

- RG 000.96 By 1 March 2013, if an existing PDS that does not contain benchmark or disclosure principle information remains in use, we expect responsible entities to:
- (a) provide the benchmark and disclosure principle information using a website or other means of communication referred to in the PDS (if the omission of the benchmark and disclosure principle information from the PDS is not materially adverse); or
  - (b) update the PDS by a new or supplementary PDS so that it includes the benchmark and disclosure principle information.
- RG 000.97 The information in a PDS must be up-to-date at the time it is given. We consider that PDSs that do not contain the benchmark and disclosure principle information by 1 March 2013 are unlikely to be up-to-date, given the key nature of this information.

## Ongoing disclosure

### Effective ongoing disclosure

- RG 000.98 If there have been any material changes to the benchmark or disclosure principle information, including information about the responsible entity's alternative approach to meeting the benchmarks, the responsible entity should explain these in ongoing disclosure.
- RG 000.99 In a PDS, a responsible entity makes a number of statements about how the funds being raised under the PDS will be used, and how the hedge fund will be operated. These statements are part of the basis on which an investor invests their money, and investors should be given the opportunity to monitor the responsible entity's performance against those statements.
- RG 000.100 Good ongoing disclosure, therefore, plays an important role in helping investors monitor their investment and evaluate its performance. Ongoing disclosure also helps investors to assess other actions they may wish to take if they believe the hedge fund is not meeting their expectations, including requesting a members' meeting.
- RG 000.101 Responsible entities have a number of obligations to make ongoing disclosure to investors under the Corporations Act: see RG 000.102. Apart from these legal requirements, we encourage responsible entities to use the most efficient and effective methods to regularly communicate key information to investors.

DRAFT

## Legal framework for ongoing disclosure

- RG 000.102 Responsible entities of hedge funds have obligations to provide ongoing disclosure to investors under the Corporations Act, including:
- continuous disclosure obligations for listed hedge funds (s675); and
  - notification of any material change to a matter that would be required to be specified in a PDS (s1017B).

## Continuous disclosure for listed hedge funds

- RG 000.103 If the responsible entity of a hedge fund that is subject to continuous disclosure under Ch 6CA becomes aware of information that is not generally available and that a reasonable person would expect, if it were available, to have a material effect on the price or value of the interests in the hedge fund, the responsible entity must lodge a document with ASIC containing the information: s675.

Note: It is good practice for responsible entities to provide investors with access to continuous disclosure documents lodged with ASIC, either by sending investors a hard copy or posting the information on a website used for updating investors.

- RG 000.104 The benchmarks and disclosure principles reflect information that would reasonably be expected to have a material effect on the price or value of interests in the hedge fund. Material changes to benchmark and disclosure principle information may therefore trigger s675, unless the information is already generally available.

## Notification of material changes and significant events

- RG 000.105 If a hedge fund is not subject to continuous disclosure obligations under Ch 6CA, the responsible entity must give investors who acquired their interests as retail clients notice of any material change to a matter, or a significant event that affects a matter, that would be required to be specified in a PDS: s1017B.

- RG 000.106 In our view, diversions from the benchmarks or changes to the benchmark or disclosure principle information are material issues that should be covered in notifications to investors under s1017B. Where such changes or events are materially adverse to investors, notifications generally need to be provided before the change or event occurs, or as soon as practicable and, in any event, within three months.

- RG 000.107 We consider that responsible entities of closed schemes should also consider the benchmarks and disclosure principles in meeting their ongoing disclosure obligations as a matter of best practice.

## Good practice for ongoing disclosure

- RG 000.108 It is good practice for a responsible entity to maintain a document addressing the benchmarks on an ‘if not, why not’ basis and applying the disclosure principles, which is updated for material changes that the responsible entity becomes aware of in the ordinary course of managing the hedge fund. This updating allows the responsible entity to provide consolidated updated disclosure to investors on request.
- RG 000.109 It is also good practice for this consolidated disclosure document to be clearly accessible on the hedge fund’s website (if used for updating investors). The consolidated disclosure document should indicate the date it was prepared and last updated.
- RG 000.110 Although it is not necessary to repeat information in these updates on the benchmark and disclosure principle information if it has not changed, we consider it is good practice to provide investors with:
- (a) an overview of any material changes to the benchmark and disclosure principle information since the last update (as far as the responsible entity is aware);
  - (b) if there have been no material changes, confirmation that this is the case;
  - (c) details of how to access the hedge fund’s consolidated disclosure document on the website (if it is available there); and
  - (d) confirmation that they are entitled to a hard copy of the benchmark and disclosure principle information on request.

Note: An alternative would be for responsible entities to provide investors with details of material changes to the benchmark and disclosure principle information using a procedure similar to that applying to the provision of a financial report under s314.

## Key terms

Term	Meaning in this document
ASIC	Australian Securities and Investments Commission
benchmark and/or disclosure principle information	Information covered by the benchmarks in Section B and/or disclosure principles in Section C of this guide
Ch 6CA	A chapter of the Corporations Act (in this example, numbered 6CA)
Corporations Act	<i>Corporations Act 2001</i> , including regulations made for the purposes of that Act
FUM	Funds under management
fund of hedge funds	A hedge fund that has invested 25% or more of its assets in an underlying hedge fund or structured product
hedge fund	A registered managed investment scheme that is, or has been promoted as, or is generally regarded as, a hedge fund or fund of hedge funds
OTC	Over the counter
PDS	Product Disclosure Statement
Product Disclosure Statement	A document that must be given to a retail client in relation to the offer or issue of a financial product in accordance with Div 2 of Pt 7.9 of the Corporations Act Note: See s761A for the exact definition.
RG 76	An ASIC regulatory guide (in this example, numbered 76)
s675	A section of the Corporations Act (in this example, numbered 675)
shorter PDS regime	The requirements set out in Div 3A of Pt 7.9 of the Corporations Act as modified by Subdivs 4.2 to 4.2C and Schs 10B, 10C, 10D and 10E of the Corporations Regulations, which prescribe the content and length of the PDS for first home saver accounts, margin loans, superannuation products and simple managed investment schemes

DRAFT

# Related information

## Headnotes

benchmarks, disclosure, disclosure principles, funds of hedge funds, hedge funds, managed investment schemes, PDS, Product Disclosure Statement, responsible entities, retail investors

## Class orders and pro formas

[CO 03/237] *Updated information in product disclosure statements*

## Regulatory guides

RG 45 *Mortgage schemes: Improving disclosure for retail investors*

RG 46 *Unlisted property schemes: Improving disclosure for retail investors*

RG 76 *Related party transactions*

RG 148 *Investor directed portfolio services*

RG 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)*

RG 231 *Infrastructure entities: Improving disclosure for retail investors*

RG 232 *Agribusiness managed investment schemes: Improving disclosure for retail investors*

## Legislation

Corporations Act, s314, Ch 6CA, s675, 1013A, 1013C, 1013D, 1013E, 1017B, 1020E

Corporations Amendment Regulations 2010 (No. 5)