ASISA CIS IN HEDGE FUNDS INVESTMENT MANAGEMENT FEE

Approved by the ASISA Board: 30 November 2018 Effective from: 1 March 2019

1 INTRODUCTION

1.1 The purpose of this standard is to create an environment of transparency and disclosure in the hedge fund industry where an Investment Management Fee is charged to the investor. This will enable the investor to compare the charging structures of various funds, understand the financial implications thereof, and make an informed investment decision. To this end, the standard aims to:

1.1.1 Guide the actions of Managers and Investment Managers where an Investment Management Fee is charged, insofar as acceptable practises and disclosure is concerned and consistent terminology is used;

1.1.2 Highlight the appropriate behaviour of Managers and Investment Managers that charge an Investment Management Fee;

1.1.3 Align the investor's interests, in terms of investment outcomes, with the interests of the Manager and Investment Manager in terms of revenue; and

1.1.4 Provide additional information and education on Performance Fee structures, and how these differ from flat fee structures, which will give investors and advisors a clearer understanding of the benefits of Performance Fee structures.

1.2 This standard embodies the following principles in the design, calculation and disclosure of an Investment Management Fee:

1.2.1 Fairness

1.2.2 Consistency

1.2.3 Transparency

1.2.4 Accuracy

1.2.5 Completeness

1.2.6 Appropriateness

1.3 Fees charged by the Manager are structured in a way that covers and provides for various costs involved with the management and administration of funds by the Manager. These include, but are not limited to:

1.3.1 Costs to manage the investments of the fund, namely the Investment Management Fee;

1.3.2 Costs to comply with regulation;

1.3.3 Costs to comply with mandate restrictions;

1.3.4 Fund administration costs;

1.3.5 IT and system operating and licensing costs;

1.3.6 Costs of reporting to investors including income tax and withholding tax; and

1.3.7 Marketing and other operational costs.

2 TERMINOLOGY

The terminology below should be used to provide consistency and transparency across the industry and to avoid confusing investors:

2.1 Base Fee: means the minimum portion of the Investment Management Fee charged for the management of the fund before any Performance Fee is taken into account, also referred to as "Management Fee or Minimum Fee";

2.2 Benchmark: means the yardstick used to measure the performance of the fund. Where Benchmark is referred to in the Performance Fee calculation, it is construed to have the same meaning as Hurdle;

2.3 Equalisation: means an accounting methodology that takes into account investor transactions during the Performance Fee Measurement Period to ensure that the Performance Fee is allocated fairly to each investor;

2.4 High Water Mark ("HWM"): means the greater of the initial subscription price of the participatory interest and:

- 2.4.1 the closing price of the participatory interest at the end of any prior Performance Fee Measurement Period; or
- 2.4.2 the closing price of the participatory interest at the end of any prior Performance Fee Measurement Period at which point a Performance Fee is paid;

2.5 Hurdle: means the level of performance the participatory interest must achieve before a Performance Fee can be charged;

2.6 Investment Management Fee: means the amount charged for managing the fund and includes both the Base Fee and Performance Fee, also referred to as the "Maximum Fee";

2.7 Investment Manager: means the discretionary financial services provider as defined in the FAIS Code of Conduct for Administrative and Discretionary FSPs, appointed by the Manager to manage the fund;

2.8 Manager: means the entity appointed to administer collective investment scheme portfolios in terms of section 42 of the Collective Investment Schemes Control Act ("CISCA");

2.9 Minimum Fee: This is the minimum annual management fee that may be recovered from the fund by the Manager;

2.10 Maximum Fee: This is the maximum annual Investment Management Fee that may in any instance be recovered from the fund by the Manager;

2.11 Performance Fee: means the amount the Manager is paid for the performance achieved, relative to the Hurdle and/or HWM, as applicable;

2.12 Performance Fee Measurement Period: means the period over which the Performance Fee is calculated, and can be a fixed or rolling period; and

2.13 Performance Fee Rate: means the percentage of performance, relative to the Hurdle and/or HWM, as applicable, that the Manager is entitled to receive as a Performance Fee.

3 THE HEDGE FUND MODEL

3.1 Hedge fund remuneration model

Hedge fund management revenue models have two inputs, namely the Base Fee, which is a fixed percentage of assets under management, and the Performance Fee, which is a percentage of the return above a Hurdle or HWM, whichever is applicable. The Performance Fee variable charging structure, when well-constructed, should align the interests of investors, Managers and Investment Managers at all times

Performance Fee structures should be appropriately designed to take into account the manner in which the fund is managed. Some of the main reasons for, and advantages of, Performance Fee structures are:

3.1.1 Demand from investors and advisors to have more options in terms of fee structures available;

3.1.2 Alignment of interests between investors, Managers, and Investment Managers, thereby discouraging investor churn between funds where the HWM principle is applied;

3.1.3 Evolution of fee structures, e.g. a move away from charging an initial fee as part of the flat fee structure to fee structures with a Performance Fee; and

3.1.4 A well-structured Performance Fee can shift the emphasis of the Investment Manager's remuneration toward the delivery of consistent superior long term returns rather than concentrating on accumulating assets under management.

3.2 The use of Benchmarks in the hedge fund industry

The practice of using benchmarks in the hedge fund industry is to assist investors by providing a reference point against which to evaluate the relative returns of the hedge fund against other asset classes.

4 PERFORMANCE FEE STRUCTURING METHODOLOGIES

There are a number of methodologies for structuring Performance Fees with numerous possible variations in the detailed operation of even seemingly similar methodologies. No single method can be deemed to be universally superior and it is for the Manager and Investment Manager to select and structure the approach most appropriate for their particular circumstances and mandate of the fund.

The following should be considered when formulating a Performance Fee structure:

4.1 Convexity

The Performance Fee structure should in no way alter the way in which the Investment Manager manages the fund in terms of the risk being taken. There are sufficient levels of regulatory controls built into CISCA, Regulation 28 and fund mandate guidelines to prevent Investment Managers from acting irresponsibly and taking excessive risk. Performance Fees should be earned in a linear manner.

4.2 Symmetry

Performance Fees add an element of symmetry that cannot be achieved in a flat fee structure and should also be viewed in context of the total Investment Management Fee to ensure that the component percentages are appropriate.

There are various ways that symmetry can be achieved in terms of the Investment Management Fee, including but not limited to the examples below:

4.2.1 Setting a lower Base Fee;

4.2.2 Fee rebate structure to investors for failure to meet certain criteria on fund performance or risk parameters;

4.2.3 Application of a HWM, as no investors (new or existing) pay a Performance Fee while the fund underperforms, and it is only levied once the HWM has been exceeded.

4.3 Base Fee

Generally, the Base Fee of a fund with a Performance Fee structure should be lower than the Base Fee of a similar product without a Performance Fee. However, the Base Fee should not be looked at in isolation, but rather as a component of the Investment Management Fee.

4.4 Key Performance Fee components

The ideal Performance Fee structure is one which is specific to each investor and their time spent invested in the fund. Unfortunately, this is not possible at an individual investor level within a daily dealing fund where equalisation for investor transactions is not administratively practical. As such, the standardization of the various Performance Fee components is critical for the fair and equitable application to all investors. Not every Performance Fee structure will necessarily comprise all of these components. The components that are used in a Performance Fee structure should be looked at in terms of the total Investment Management Fee and the nature of the particular fund or mandate.

4.4.1 Performance Fee Measurement Period

A longer measurement period better allows for the skill of the Investment Manager to be rewarded, and should achieve closer alignment of interests between the investor, Manager and Investment Manager. It should also result in a lower level of volatility in Performance Fees and prevent churn within the fund.

4.4.2 Performance Fee calculation methodologies

The Performance Fee can be calculated using one of the following methodologies:

4.4.2.1 Return above HWM;

4.4.2.2 Return above HWM, subject to the return being greater than the Hurdle;

4.4.2.3 Return above HWM, subject to the return, after the Investment Management Fee, not being less than the Hurdle;

4.4.2.4 Return above Hurdle.

4.4.3 Hurdle

When selecting a Hurdle, Managers should ensure that it:

4.4.3.1 is relevant to the investment objectives and mandate of the fund;

4.4.3.2 is easily verifiable to an independent source;

4.4.3.3 is calculated on a total return basis, if applicable;

4.4.3.4 can be consistently applied; and

4.4.3.5 is transparently disclosed and explained.

4.4.4 High Water Mark

The HWM principle is widely used and ensures that investors do not pay Performance Fees twice for the same performance. If the HWM principle is applied, this must be disclosed. If the HWM principle is not applied, this must be disclosed.

4.4.5 Equalisation

Equalisation is designed to ensure that not only is the Investment Manager paid the correct Performance Fee, but also that such fee is fairly allocated between each investor in the fund. The application of equalisation is good practise and is encouraged where practical. The two most commonly used equalisation methodologies are:

4.4.5.1 Multi Series Equalisation

A new series of participatory interests is issued at each subscription date after a Performance Fee Measurement Period has already commenced. The Investment Management Fee is calculated separately for each series based on the actual period invested, which would initially be shorter than the full Performance Fee Measurement Period, resulting in a different NAV price per series. This is the simplest form of equalisation making it uncomplicated to calculate the Performance Fee at an investor level.

4.4.5.2 Adjustment Equalisation

This is an equalisation method that retains a single price per class of participatory interest. Equalisation credits are issued to investors if a Performance Fee has been accrued during the current Performance Fee Measurement Period, prior to the date of the investors' subscription for participatory interests. If no Performance Fee has been accrued during the same Performance Fee Measurement Period, due to the NAV being less than the level required to generate a Performance Fee, equalisation deficits are issued to the investor for their subscription for participatory interests.

If equalisation is applied this, and the methodology must be disclosed. If equalisation is not applied, this must be disclosed.

4.4.6 Caps

Investment Management Fee structures may have a cap. If a cap is applied, the method of calculation of the cap must be disclosed. If a cap is not applied, this must be disclosed.

4.4.7 Performance Fee Rate

The Performance Fee Rate should be considered in conjunction with the Base Fee, the Hurdle and the components of the Performance Fee structure. In general, the more demanding the Hurdle and the lower the Base Fee, the higher the Performance Fee Rate could be and vice-versa.

5 DISCLOSURE

There should be comprehensive and complete disclosure of the Investment Management Fee. The upfront disclosure should be publicly available in order to facilitate comparison between various funds. Disclosure should be clear, relevant to the particular class that an investor is investing in, and should not confuse investors when covering the technical details of the Investment Management Fee.

The Investment Management Fee disclosure should include the following:

5.1 Basis

The basis refers to the relevant components used when calculating the Investment Management Fee. The following are examples of disclosures considered industry best practise:

5.1.1 Base Fee

The maximum Base Fee is xx% per annum, excluding/including VAT.

5.1.2 Hurdle

The Hurdle is xxx [insert full name and/or description, e.g. percentage change in the STeFI] as quoted by xxx [e.g. Bloomberg].

5.1.3 Performance Fee Rate

5.1.3.1 Class xx: The Investment Manager shall be entitled to charge a Performance Fee Rate of xx%, excluding/including VAT of the performance achieved; or

5.1.3.2 Class xx: The Investment Manager shall be entitled to charge a Performance Fee Rate of xx%, excluding/including VAT of the performance achieved in excess of the Hurdle.

5.1.4 HWM

5.1.4.1 The HWM principle is applied; or

5.1.4.2 The HWM principle is not applied.

5.1.5 Equalisation

5.1.5.1 Equalisation is an accounting methodology designed to ensure that the Investment Manager is paid the correct Performance Fee and that the Performance Fee is fairly allocated between investors in the fund. Multi Series equalisation is applied [insert a brief description of methodology]; or

5.1.5.2 Equalisation is an accounting methodology designed to ensure that the Investment Manager is paid the correct Performance Fee and that the Performance Fee is fairly allocated between investors in the fund. Adjustment equalisation is applied [insert a brief description of methodology]; or

5.1.5.3 No equalisation methodology is applied.

5.1.6 Cap

5.1.6.1 The Investment Management Fee/Performance Fee is capped at xx% per annum over a xxx [specify capping period] period; or

5.1.6.2 The Investment Management Fee/Performance Fee is capped at Rxx over a xxx [specify capping period]; or

5.1.6.3 There is no cap on the Investment Management Fee/Performance Fee.

5.2 <u>Method of calculation of the Investment Management Fee</u>

The method of calculation of the Base Fee and the Performance Fee should be disclosed. The following examples of disclosures of calculation methodologies are considered industry best practise:

5.2.1 Base Fee

The Base Fee is calculated and accrued xxx [insert frequency, e.g. daily/monthly/quarterly] by multiplying the xxx [insert AUM base] by xx% [insert the Base Fee percentage] and dividing by [insert frequency, e.g. 365/12 etc.]. The Base Fee is paid xxx [insert frequency, e.g. monthly/quarterly/annually].

5.2.2 Performance Fee

The Performance Fee is calculated and accrued xxx [insert frequency, e.g. daily/monthly, etc.], based on the performance achieved during the xxx [insert period, e.g. daily/monthly, etc.] or over a rolling xxx [insert period, e.g. daily/monthly, etc.] multiplied by xx% [insert Performance Fee Rate]. The Performance Fee is paid xxx [insert frequency, e.g. monthly/quarterly, etc.].

6 FREQUENTLY ASKED QUESTIONS DOCUMENT

Where a Manager charges an Investment Management Fee, either they or the Investment Manager must develop an Investment Management Fee Frequently Asked Questions document ("FAQ document") for investors, in respect of any class of any fund. A Manager or Investment Manager, as the case may be, may group different classes, funds, Investment Managers and/or Investment Management Fee structures as deemed appropriate. The FAQ document should be specific to the Manager's fund/s, Investment Manager's fund/s, Investment Management Fee structure/s and should address specific questions that an investor may ask of that Manager or Investment Manager. The FAQ document should be a free of charge, public document, which should be easily accessible and the Manager and/or Investment Manager must state where the FAQ document can be accessed. The FAQ document should include the following:

6.1 What is a Base Fee? [give a brief explanation of what a base fee is]

6.2 What is a Performance Fee? [give a brief explanation of what a performance fees is]

6.3 What is the Performance Fee Rate for this fund?[indicate the performance fee rate charged per class]

6.4 Do any other classes of the fund charge a Base Fee only, instead of a Base Fee and a Performance Fee?

6.5 What is the High Water Mark principle ("HWM")? [give a brief explanation of what the HWM principle is]

6.6 Does the fund apply the HWM? [If yes, explain whether Performance Fee accruals are simply suspended or whether past Performance Fee accruals are reversed. Also, disclose the circumstances under which the HWM expires, if at all]

6.7 Does the fund apply Equalisation in the calculation of the Performance Fee? [If yes, indicate which method is used]

6.8 Is there a Hurdle? [If yes, what is the Hurdle?]

6.9 How long is the Performance Fee Measurement Period? [indicate duration]

6.10 How often is the Performance Fee paid to the Investment Manager?

6.11 Will more than the Base Fee be charged regardless of whether the fund is experiencing positive or negative performance over the Performance Fee Measurement Period?

6.12 Should the fund experience under performance relative to the Hurdle, how long until the Investment Manager is entitled to earn a Performance Fee?

6.13 Do any underlying funds charge Performance Fees?

6.14 If the fund underperforms, can the underlying funds still charge Performance Fees?

7 EFFECTIVE DATE

The effective date for the Standard is **1 March 2019**.