THE IMPACT OF REGULATION OF THE SOUTH AFRICAN ASSET MANAGEMENT INDUSTRY

by

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The Impact of Regulation of the South African Asset Management Industry

I declare that the above dissertation is my own work and that all the sources that I have used or quoted have been indicated and acknowledged by means of complete references.

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SIGNATURE DATE

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SUMMARY

The primary objective of this dissertation is to assess the impact of regulation on the asset management industry. The secondary aims of the study are to investigate whether the South African asset management industry regulation is aligned towards creating an enabling economic environment, analyse the regulatory regime affecting the asset management industry and provide recommendations regarding the strategies that may be adopted by asset managers, in order to effectively and efficiently comply with existing and new regulations. A quantitative research methodology was adopted. A survey was conducted by means of questionnaire design. The questionnaire was administered to a sample of asset management companies registered with the Financial Services Board.

Through empirical research the researcher gained in-depth knowledge regarding the impact of regulation on the asset management industry. There is an appreciation of the economic importance of the asset management industry, as a creator of employment and its effect on the growth and development of the South African economy in general. The regulation of the asset management industry contributes towards an enabling economic environment and development of the industry.

The rationale and objectives of regulation of the asset management industry, as it pertains to systematic issues associated with externalities, market imperfections and failures, economies of scale in monitoring, consumer confidence and the consumer demand for regulation, would seem to justify the existence and development of compliance requirements. Regulation must however balance the goals of competition and efficiency versus safety and soundness. The current regulatory universe applicable to the asset management industry is justifiable, beneficial and is achieving the intended objectives.

The rapid changes in regulation and costs of regulation of the asset management industry, which entails utilisation of resources such as personnel, time and systems required and limitation on investment freedom and creativity, remain the cause for

concern. However based on the outcomes of the research, there is adequate evidence to suggest that the benefits of regulation of the asset management industry outweigh the costs thereof.

The outcomes of the research suggest that under the new paradigm, success will be determined by how asset managers can solve several key challenges such as enhancing operational efficiency, complying with the complex and rapidly changing regulatory environment and meeting the changing customer expectations. The new era of compliance will force asset managers to focus on an enterprise-wide integration of business strategy and not simply short-term tactical solutions. For asset managers that effectively meet the challenge of the changing regulatory environment, substantial investments in infrastructure or data architecture and implementation of an enhanced operating model will provide opportunities to enhance profitability and ensure growth.

Selected key terms:
Regulation; costs; benefits; asset management; and compliance strategies.

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List of Abbreviations

ASISA	-	Association for Savings and Investment South Africa
AUM	-	Assets Under Management
BESA	-	Bond Exchange of South Africa
CA (SA)	-	Chartered Accountant South Africa
CBA	-	Cost-Benefit Analysis
CFA	-	Chartered Financial Analyst
CIPC	-	Companies and Intellectual Properties Commission
CIS	-	Collective Investment Scheme
CPD	-	Continuous Professional Development
DBSA	-	Development Bank of South Africa
DTI	-	Department of Trade and Industry
EFT	-	Electronic Funds Transfer
FAIS Act	-	Financial Advisory and Intermediary Services Act
FDI	-	Foreign Direct Investment
FIC	-	Financial Intelligence Centre
FICA	-	Financial Intelligence Centre Act
FMA	-	Financial Markets Act
FSCA	-	Financial Sector Conduct Authority
FSB	-	Financial Services Board
FSP	-	Financial Services Provider
FSRB	-	Financial Sector Regulation Bill
GEPF	-	Government Employees Pension Fund
GDP	-	Gross Domestic Product
IMF	-	International Monetary Fund
JSE	-	Johannesburg Stock Exchange
LISP	-	Linked Investment Service Provider
LSE	-	London Stock Exchange
NCR	-	National Credit Regulator

NPA	-	National Prosecuting Authority
NYSE	-	New York Stock Exchange
PFA	-	Pension Funds Act
PA	-	Prudential Authority
PIC	-	Public Investment Corporation
QLFS	-	Quarterly Labour Force Survey
RBS	-	Risk Based Supervision
SAFEX	-	South African Futures Exchange
SARB	-	South African Reserve Bank
SARS	-	South African Revenue Service
SAVCA	-	South African Venture Capital and Private Equity Association
SENS	-	Stock Exchange News Service
SME	-	Small and Medium Enterprises
SPSS	-	Statistical Package for Social Sciences
STATSSA	-	Statistics South Africa
STR	-	Suspicious and Unusual Transactions
TCF	-	Treating Customers Fairly
TRP	-	Takeover Regulation Panel
UK	-	United Kingdom
USA	-	United States of America
WEF	-	World Economic Forum

Chapter One: Introduction

1.1 Introduction

South Africa was ranked 123rd out of 144 countries in terms of the burden of government regulation, according to the World Economic Forum Global Competitiveness Report for 2012/13 (WEF 2013: 325). This finding raises questions regarding the impact of the applicable regulatory universe, in achieving the intended objectives of, amongst others, creating the conditions of an enabling economic environment. According to Botes (2013: 01-03), regulatory compliance is bad for businesses. He further argues that some businesses need to comply with more than 45 laws and have to submit up to 24 returns and that the time that it takes to comply with all these regulations can be a substantial cost to the business.

It has been observed over a period of time that regulatory arrangements have a significant impact on the efficiency of a financial system, financial markets and business operations (Falkena, Bamber, Llewellyn, Store 2001). In the debate regarding strict regulations versus lenient regulations, Rose & Hudgins (2010: 33) argue that lifting financial regulations would subject financial services providers to greater risk and eventually result in more failures. Consumers have limited capacity to effectively monitor complex financial products, so prudent financial regulations are critical to maintaining the stability of the financial sector (Kima, Koob, & Park 2013: 662-272). Gill Marcus, the former Governor of the South African Reserve Bank, in the foreword to the book Financial Regulation in South Africa, (Falkena *et al* 2001) states that an efficient and effective regulatory system is core to a nation's economic wellbeing.

The government's intention is to use regulation in the financial services sector to create an enabling economic environment. In addition to the preservation of financial stability, the objective of financial services regulation is to promote consumer protection, the

improvement of access to financial services for the poor, and the combating of financial regulation (Van Eeden 2013: 576-581). These regulations will accrue benefits to various stakeholders in the economy but will also result in costs being incurred by certain stakeholder groups. To achieve the objectives of the enabling economic environment, it is important that these benefits exceed the costs.

According to the University of Cape Town (2014: 63) portfolio management is all about strengths, weaknesses, opportunities and threats in the choice of debt versus equity, domestic versus international, growth versus safety, and various other trade-offs encountered in the attempt to maximize return at given appetite for risk. It is the art and science of making decisions about investment mix and policy, matching investments to objectives, asset allocation for individuals and institutions, and balancing risk against performance.

1.2 Problem identification

The financial sector is one of the areas in which the regulatory source imbalances have been most pronounced over the years. Professional, structural and cultural embeddedness condition the interplay of regulatory authority and regulatory responses (O’ Brien & Gilligan 2013).

The challenge regarding regulation is that it is viewed as a burden towards asset management industry’s development and growth and consequently it is not adequately appreciated and entrenched within the business. There are still efforts required to effectively and efficiently integrate compliance into the business processes, in order to achieve the objectives of an enabling and sound business environment. It is important for compliance to be viewed as part of the business as opposed to a separate process from business activities.

The dissertation will concentrate largely on the impact of regulation on asset managers and their contribution towards economic growth. The impact of regulation on asset managers and appropriate compliance strategies are not adequately researched. This study is therefore crucial in determining and analysing the cost and benefits of regulation of asset managers, in relation to economic growth and development. Ascertaining the cost and benefits would provide business and policy-makers with valuable information regarding the comparative advantages and disadvantages of the nature and extent of regulation of the asset management industry.

The global financial crisis in 2007-2008 has brought about a shift in the regulation of certain significant role players in the South African asset management industry. The key features of this shift included, amongst others, the move by the South African regulators to oversee and control investment vehicles and activities, which previously enjoyed limited oversight and the use of increasingly sophisticated regulatory measures. For example, the introduction of Regulation 28 (published in 2011) as informed by the Pension Funds Act, limits the maximum exposure of a pension fund in respect of equity securities to 75 per cent of the aggregate fair value of the total assets of a fund, and further provides that the total exposure in respect of unlisted securities and hedge funds, may not exceed 35 per cent (Law Business Research 2012: 361-390).

Another example is the introduction of regulatory examinations Level 1 and Level 2, in terms of the Financial Advisory and Intermediary Act, 37 of 2002 (the FAIS Act). The key individuals and representatives of financial service providers are required to write Level 1 regulatory examinations, which seek to assess their knowledge regarding the FAIS Act and the Financial Intelligence Centre Act, 38 of 2001 (FICA). On the other hand, Level 2 regulatory examinations seeks to assess the key individuals and Representatives' level of knowledge and understanding of the various financial products that they render advisory and intermediary services on, such as short-term and long-term insurance products, pension funds, equities, bonds, money markets, warrants, debentures, derivatives and participatory interest in collective investment schemes. Moreover, the

Treating Customers Fairly (TCF) principles have also been introduced recently. These regulatory developments and changes are likely to create additional burden on business, in their quest to ensure compliance with the new requirements.

1.3 Objectives of the study

The primary objective of this dissertation is to assess the impact of regulation on the asset management industry. Knowledge of the financial services sector is crucial in analysing the role of asset managers, as a creator of employment and its effect on the growth and development of the South African economy in general.

The secondary aims for the study are as follows:

- To investigate whether the South African asset management industry regulation is aligned towards creating an enabling economic environment;
- To assess the regulatory regime affecting the asset management industry; and
- To provide recommendations regarding the strategies that may be adopted by asset management companies, in order to effectively and efficiently comply with existing and new regulations.

An enabling economic environment is widely desired by policymakers and practitioners. According to Kirkpatrick and Piesse (2001), an environment can be considered enabling when it provides conditions that encourage the growth of private sector activity and enterprise development and place the economy on a long-term, sustainable development trajectory. Calamitsis (1999: 9) describes it more generally as “an overall environment within which sound economic and financial policies can have the best prospects of success”. This environment should especially focus on the development of small and micro-enterprises as a means of promoting employment, increasing output and alleviating poverty.

There exists a multiplicity of connotations attached to the term “Asset Management”. In its most generic form, it refers to a system or process designed to monitor, manage, maintain and optimize the physical aspects of assets, along with their associated financial impact within a given entity. Within a financial context however, “Asset Management” is synonymous with the terms “investment management” and “portfolio management”. Investment Management, also referred to as portfolio management, refers to the professional management of a wide variety of financial securities as well as certain real assets, with the aim of achieving a pre-specified investment goal or target set forth by the investors (University of Cape Town 2014: 63-64). The process of asset management constitutes a complex series of activities, which includes the intricacies of the core investing philosophy along with associated administration, compliance and regulatory considerations.

1.4 Importance of the study

The research topic is important because most previous studies relating to the financial services industry were mainly looking at other economic sectors such as banking. There was for example a research titled “the cost-benefit of regulation in South African banking” (Quiding 2006). Another related study was titled “the impact of financial regulation on banking in developing countries” (Manamela 2012). Lastly, there was another research conducted titled “performance factors in the hedge fund industry” (Khalaki 2002). This current research therefore becomes unique and different in that it focusses specifically on regulation of asset managers.

The significance of the asset management industry, particularly as it relates to its contribution towards employment creation and economic growth needs to be thoroughly assessed. Moreover, the asset management industry plays an important role in terms of creation of wealth and income generation for individuals and corporates, respectively, given the complex financial products and investment instruments that are utilised to generate better returns. It is therefore crucial that this industry is fairly and adequately

regulated to mitigate the risk of corporate failures and financial losses by clients. In efforts to balance the costs of regulation against the benefits, it is important to investigate and recommend the strategies that may be adopted by asset management companies, in order to effectively and efficiently comply with existing and new regulations.

The need for the development and implementation of sound and reasonable regulation of asset managers is imperative for a country's ability to raise employment and sustainable economic growth. The impact of regulation on asset managers is studied and analysed in relation to the generally and internationally accepted primary objectives of financial regulation, which can be summarised as follows (Van Zyl, Botha & Skerritt 2003: 121):

- Promoting the fair treatment of consumers of financial services and products;
- Ensuring that financial markets are fair, efficient and transparent; and
- Reducing systematic risk and financial crime.

1.5 Research procedure and methodology

According to Burns and Bush (2010: 241), the collection of primary data for academic purposes is achieved through experiments, observations and surveys. Unlike in experiments or observations where the characteristics under observation are known in advance, a survey focuses on unknown characteristics of a particular population. Saunders, Lewis and Thornhill (2007: 244) explain that the use of questionnaires in descriptive research that investigates attitude, opinions and the decisions that humans make enables a researcher to identify and describe important variations in different settings.

Hofstee (2006) explains that survey-based research may be authoritative in determining the influences of human actions and also testing for human actions. Kahneman and Tversky (1979:263) developed the prospect theory by using surveys as a research tool.

Consequently, the empirical research conducted in this study takes the form of a survey aimed at a selected sample of asset management companies in South Africa.

The primary sources of information are text books, journals, newspaper articles, government gazettes and policy documents. A quantitative research methodology was adopted. We conducted a survey by means of a questionnaire, after selecting a sample from a population of asset management companies registered with the Financial Services Board (FSB).

A sample of participants, consisting of Compliance Officers and Management (i.e. Portfolio Managers/ Key Individuals), were sent the questionnaire to provide feedback. The FAIS Act defines a Key Individual as a person that manages and oversees the business activities (i.e. the rendering of financial advice and/ or intermediary service) of a financial services provider. The sample consists of asset managers based in mainly Gauteng and Western Cape, as they constitute the majority of asset managers in South Africa. The sample of asset managers selected consists of Developmental Managers (Incubation Managers) and Well Established Managers, in order to obtain well balanced and representative view. The data collected was analysed by using mainly descriptive statistics, amongst others, bar charts, pie charts and tables, in discussing and describing the results.

The purpose of the questionnaire in the current study was to determine the impact of regulation on various asset management companies. The respondents were asked, amongst others, about their view on:

- The costs and benefits of regulation of asset managers;
- Whether the regulation affecting asset managers is justified;
- The strategies adopted to ensure compliance;
- The objectives for establishment of a compliance function; and

- Whether the regulation of asset managers is aligned towards creating an enabling economic environment;

The following core legislations are looked at in detail in Chapter 3:

- Financial Advisory and Intermediary Services Act, 2002 (FAIS Act)
- Financial Markets Act, 2012 (FMA)
- Financial Intelligence Centre Act, 2001 (FICA)
- Companies Act, 2008
- Pension Funds Act, 1956 (Regulation 28)

The above legislations are primarily dominant in terms of the extent of regulation of financial markets and instruments and the time and resources required to mitigate the risk of non-compliance. Thus, it is imperative that a thorough investigation is conducted by assessing the implications of these legislations.

A preliminary questionnaire was designed to obtain sufficient information to draw proper conclusions in respect of the possible impact of regulation on asset management companies. The questionnaire formed the basis of a pilot study, which was used to test the effectiveness of the questionnaire in gathering the required information so that it does not become too long or ineffective. Aspects such as the time needed to complete the questionnaire, the clarity on questions, possible omissions with regards to topics, as well as questions that the pilot group may feel uneasy about answering, were addressed and identified through the pilot study.

Compliance Officers and Portfolio Managers (Management) are the compliance and business experts respectively, in the field of asset management. Thus, their skills, together with their experience, suggest that they would constitute a reliable sample. A covering letter explaining the purpose of the study, as well as request for informed consent from the individual participants was sent through emails, to the Compliance

Officers and Portfolio Managers. This was to ensure that the data is collected in a uniform way and that the questions are asked and answered in the same way in order to render the data reliable and accurate.

The research focused on the South African asset management industry. The inclusion of other categories of Financial Services Providers may skew the results and place the study at the risk of becoming too general.

1.6 The division of chapters

Chapter 1 provides the introduction and identifies the problem statement, the objectives and importance of the study and the research methodology in detail.

Chapter 2 introduces a brief description and background to the development, growth and the problems of the financial services sector, with specific reference to the asset management industry. It assesses the contribution of the asset management industry towards employment creation and economic growth (gross domestic product), by looking at the trends from reputable organisations such as Statistics South Africa, South African Reserve Bank and the Department of Trade and Industry, with the aim to assess the importance of the sector.

Chapter 3 assesses the regulatory regime in the South African Asset Management Industry, by investigating the rationale and objectives of regulation. The chapter further looks at how regulation is used to address market failure, as well as measures for assessing regulatory quality and the unintended consequences of regulation.

Chapter 4 analyses the impact of regulation on investment management companies. It investigates whether the current applicable legislative universe is justified and beneficial, including whether it is achieving the intended objectives. It looks at the efficient and effective strategies that may be adopted by asset management companies, for purposes

of ensuring compliance with regulations. It also assesses how these approaches may be employed with a view to minimise compliance costs, without compromising compliance standards and levels.

Chapter 5 gives a summary of the main findings of the study. It draws some conclusions on the various aspects discussed in different chapters. Lastly, recommendations are provided relating to the challenges discovered with regard to regulation of the asset management industry.

1.7 Conclusion

The need for the development and implementation of sound and reasonable regulation of asset managers is imperative for a country's ability to raise employment and ensure sustainable economic growth. The study seeks to assess the impact of regulation on the asset management companies. In the light of scarcity of resources, there is a need for efficient utilization of resources in order to ensure compliance and minimise the costs of regulation. It is therefore imperative to adopt possible strategies to comply with applicable laws while optimising resources.

Chapter Two: The historical background of the financial services sector

2.1 Introduction

The chapter provides a brief description and background to the development, growth and the problems of the financial services sector, with specific reference to the asset management industry. It assesses the contribution of the asset management industry towards employment creation and economic growth (gross domestic product), by looking at the historical figures from reputable organisations such as Statistics South Africa, South African Reserve Bank and the Department of Trade and Industry. The financial sector is at the heart of the South African economy and touches on the life of each and every citizen (National Treasury 2011: 1-2). Financial services allow people to make daily economic transactions, save and preserve wealth to meet future aspirations and retirement needs, and insure against personal disaster.

Growth potential in South Africa is conditional on various factors such as the acceleration of global growth (PWC 2015: 28). Overall activity in both developed and emerging market economies regained momentum in the second quarter of 2014 as conditions improved following a weak first quarter that was induced by temporary obstructions to growth (SARB 2014a: 1-3). Expectations for economic growth in 2014 in sub-Saharan Africa continued to be relatively upbeat. Employment creation in the domestic private sector has been sluggish since the 2008/09 economic recession. According to Statistics South Africa (2016a: 2-5) South Africa’s labour market continued to perform poorly, with the unemployment rate remaining stubbornly high at 26.6% in 2016Q2.

2.2 The role of the financial sector in the economy

The financial system may be defined as a set of arrangements embracing the lending and borrowing of funds by non-financial economic units. The financial institution plays an intermediary role and facilitates the transfer of funds and provides additional money when required, so that the price and allocation of funds are determined efficiently (Falkena, Fourie & Kok 1995: 7). The economic function of financial markets is to provide channels for transferring the excess funds of surplus units to deficit units (Falkena, Fourie & Kok 1995: 15).

The World Economic Forum Global Competitiveness Report (2013: 325) found that South Africa was ranked number 2 out of 144 countries in terms of the availability of financial services. The availability of financial services refers to the provision of a wide variety of financial products and services to clients and includes financial products such as insurance products, equities, bonds, money markets, derivatives, warrants, debentures and securitized debt, forex investment business, participatory interests in collective investment schemes and bank deposits. The economic policy of a country determines the philosophy that underlines its approach to regulation. South Africa currently follows largely a market-oriented approach with regard to the role and operation of the economy (van Wyk 2011). This implies minimum intervention by the authorities as the market mechanism is assumed to achieve the highest efficiency of the economy in terms of the allocation of resources. However markets that follow this approach acknowledge that market imperfections do occasionally arise and that intervention by the authorities by way of regulation is sometimes justified.

Given the critical role of financial services in expanding economic opportunity, a reluctant industry may be regulated or otherwise encouraged to expand its markets by national governments (Sutton & Beth 2007: 8). By taking proactive approaches to increasing economic opportunity, individual financial institutions - and the industry as a whole - can

minimize political controversy and the prospect of government regulation, while at the same time addressing a critical issue.

The problem that government grapples with is that in order to reduce unemployment, faster economic growth must be achieved. Economic growth is achieved by *inter alia* an increase in foreign direct investment (FDI) and domestic investment spending. A robust regulatory environment in turn encourages investment spending (Kirkpatrick *et al* 2005). However, there is an equally compelling argument that the key to reducing unemployment lies in deregulation (Kirkpatrick *et al* 2005). Incentives should accordingly be established for employers to expand their businesses and reduce the cost of hiring labour. These steps are necessary in order to ensure that additional business can be translated into more jobs (McAleese 2004).

According to Blejer (2006: 3431), the financial system's efficiency can be gauged by the efficiency with which it transforms resources into capital. In other words, the financial sector functions efficiently if it intermediates at a minimum price and reduces the comprehensive costs of capital to its optimal level (Blejer 2006: 3431). As alluded to, the crucial role played by the financial sector in an economy cannot be overemphasized by anything other than the consequences of an unstable financial sector (Liu and Seeiso 2012: 848). In the developing world, financial sectors are generally still in the early phases of development and capital markets are generally thought to be weak or almost non-existent, with the exception of South Africa (Turk-Ariss 2009: 694). As a result, financial markets are dominated by bank-financed credit mechanisms (Lui and Seeiso 2012).

On the other hand, South Africa, despite its emerging market status, has a sophisticated financial sector. Disclosure, transparency and accountability have become an integral part of doing business in South Africa. Consequently, regulations governing the financial sector, and particularly risk management, have undergone considerable refinement to align them to internationally recognized standards and best practice (Media Club South Africa 2014: 02).

According to Levine (1997: 688-726), the economists hold startlingly different opinions regarding the importance of the financial system for economic growth. Bagehot (1873) and Hicks (1969) argue that it played a critical role in igniting industrialization in England by facilitating the mobilization of capital for "immense works". Schumpeter (1912) contends that well-functioning banks spur technological innovation by identifying and funding those entrepreneurs with the best chances of successfully implementing innovative products and production processes. In contrast, Robinson (1952: 86) declares that "where enterprise leads finance follows". According to this view, economic development creates demands for particular types of financial arrangements, and the financial system responds automatically to these demands. Moreover, some economists just do not believe that the finance-growth relationship is important. Robert Lucas (1988: 6) asserts that economists "badly over-stress" the role of financial factors in economic growth, while development economists frequently express their skepticism about the role of the financial system by ignoring it (Chandavarkar 1992).

The dynamic product-development interaction between intermediaries and markets can be interpreted as part of a "financial-innovation spiral" pushing the financial system toward an idealized target of full efficiency. That is, as products such as futures, options, swaps, and securitized loans become standardized and move from intermediaries to markets, the proliferation of new trading markets in those instruments makes feasible the creation of new custom-designed financial products that improve "market completeness". To hedge their exposures on those products, the producers, financial intermediaries, trade in these new markets and volume expands; increased volume reduces marginal transaction costs and thereby makes possible further implementation of more new products and trading strategies by intermediaries, which in turn leads to still more volume. Success of these trading markets and custom products encourages investment in creating additional markets and products, and so on it goes, spiraling toward the theoretically limiting case of zero marginal transactions costs and dynamically-complete markets (Merton 1995: 26-27).

2.3 The emergence and growth of the Asset Management Industry

A number of critical developments have allowed the asset management industry to grow into a globally competitive business and thrive. South Africa has a long history of institutional pension fund and unit trust investing (WWF-SA 2011: 09-16). The first occupational pension fund was established in the Transvaal Republic in 1882. By the time the Pensions Fund Act was enacted in 1956, there were 1 200 pension funds. In 1989, the abolition of prescribed assets and the introduction of Regulation 28 prudential investment limits had further fostered a strong culture of active equity investment in South Africa. The first unit trusts came in 1965 and by June 2015 the industry had R1.8 trillion of assets under management (ASISA 2015: 01).

Table 1 - Size of Investment and Savings Industry

Category	Subcategory	ZAR Millions	Date	Source
Traditional non-linked insurance		1 291 330	31-Dec-2014	SARB & ASISA
CIS Portfolios		1 694 795	31-Dec-2014	ASISA
Retirement Funds		3 984 644		
	Privately administered and underwritten funds	2 112 597	31-Dec-2014	SARB & FSB
	Officially administered funds	1 872 047	31-Dec-2014	SARB
Total Investment and Savings Industry		**6 970 769**		

Source: BEE.conomics (2015: 13)

Figure 1 - Assets Under Management Quarterly Growth Patterns

Source: BEE.conomics (2015: 2)

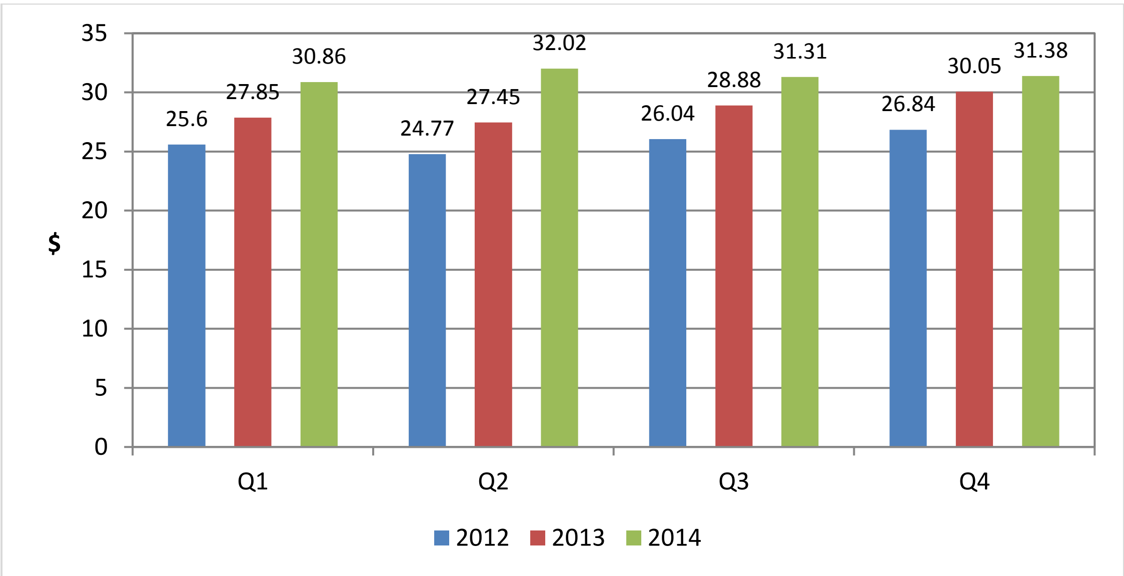
Table 1 and Figure 1 reflect that the size of the total South African investment and savings industry was about R6.97 trillion in 2014 (BEE.conomics 2015: 4). Figure 1 reflects slow growth in assets under management (AUM), which stood at less than a trillion, for the period December 2011 to March 2013, following the 2008-2009 financial crisis which impacted negatively on global economic growth in general. This was followed by rapid increase in AUM for the period March 2013 to June 2015. This could be attributable to the growth of economic activities in the financial markets, including increase in capital and market participants as well as performance of investments. The data from the FSB indicates that there were 5,144 pension funds in South Africa in 2013, of which 3,292 were privately administered. The Government Employees Pension Fund (GEPF) is by far

the largest fund in South Africa, with AUM of about R1.4 trillion, comprising almost half of the assets of pension funds in South Africa (PWC 2015: 25).

The evolution of financial markets had a progressive influence on both the complexity and available opportunities. Across the world, investors are offered a wide range of investment opportunities- some with great success, others not. Products to manage the risk of financial markets are developing rapidly. Volatile and uncertain financial markets continuously force portfolio managers to develop new instruments to hedge their portfolios (Van der Berg 2002: 23).

Figure 2 - World Wide Mutual Fund Assets

Trillions of U.S. dollars, end of quarter



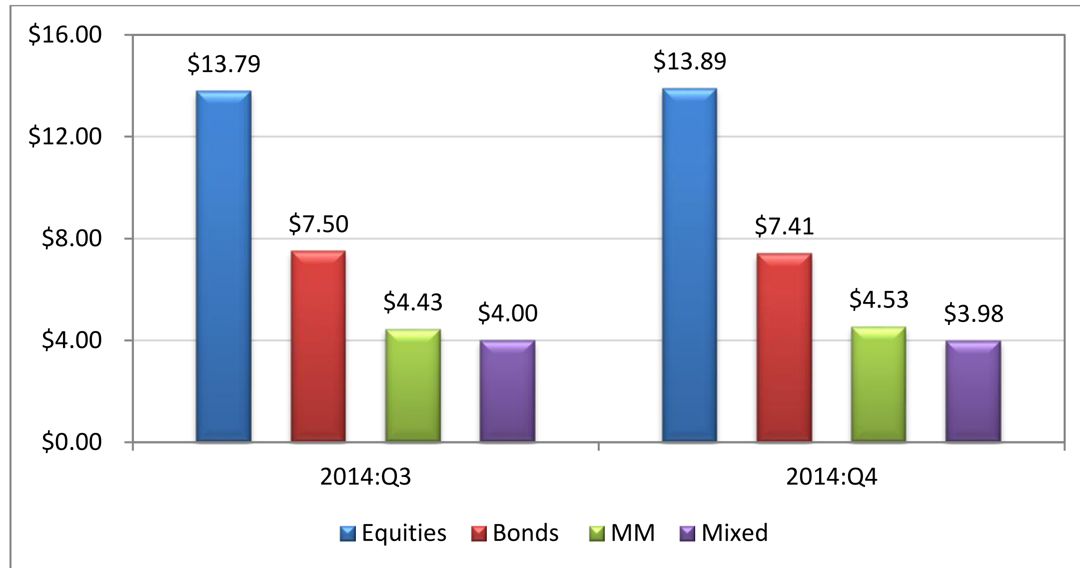
Source: Investment Company Institute (2015: 1)

Figure 2 shows that mutual fund assets worldwide increased by 0.2%, from $31.31 trillion in the third quarter of 2014 to $31.38 trillion at the end of the fourth quarter of 2014. Worldwide net sales to all funds were $364 billion in the fourth quarter, compared to $322 billion of net inflows in the third quarter of 2014, and worldwide net sales were $1.33 trillion in 2014, the highest annual flow since 2007 (Investment Company Institute 2015).

Overall, worldwide mutual funds have experienced a steady growth as reflected by the increase in the value of the funds from 2012 to 2014.

Figure 3 - Worldwide Assets of Equity, Bond, Money Market, and Mixed Funds

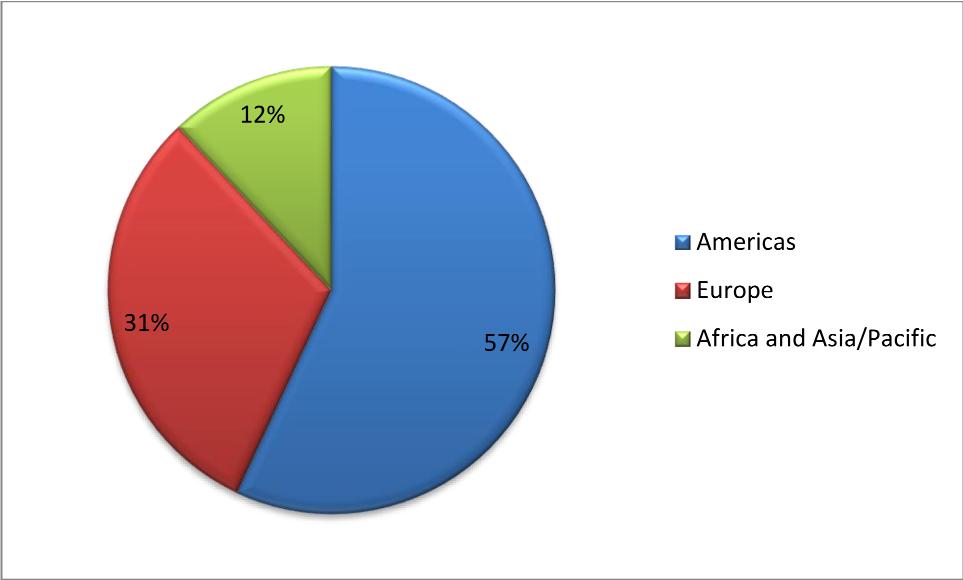
Billions of U.S. dollars, end of quarter



Source: Investment Company Institute (2015: 2)

Figure 3 reflects that equity fund assets increased by 0.7%, from $13.79 trillion to $13.89 trillion at the end of the fourth quarter of 2014. Bond fund assets decreased 1.2%, from $7.5 to $7.4 trillion in the fourth quarter. Balanced/mixed fund assets fell 0.5% in the fourth quarter, while money market fund assets rose 2.3% globally (Investment Company Institute 2015: 2). The decrease in bonds and mixed funds from quarter 3 to quarter 4 could be attributable to the decrease in demand for these instruments. Generally, most short term to medium investors (mainly retail clients, but also institutional) prefer investments in securities and instruments such as equities and money markets, while long term investors (mainly institutional) prefer bonds instruments.

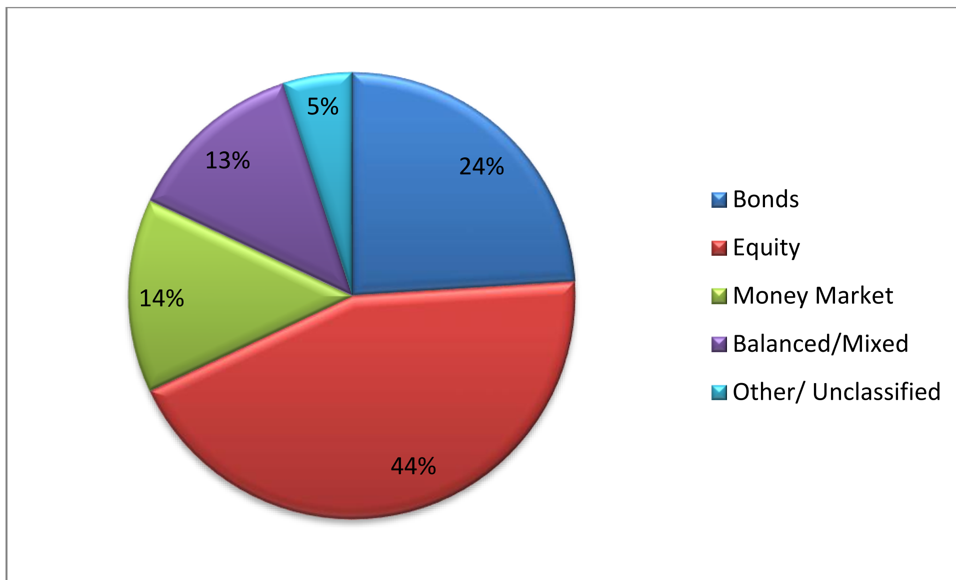
Figure 4 - Percentage of Worldwide Mutual Funds by Region, 2014: Q4



Source: Investment Company Institute (2015:4)

According to figure 4, by region, 57% of worldwide assets were in the Americas in the fourth quarter of 2014, 31% were in Europe, and 12% were in Africa and the Asia and Pacific region. This reflects the dominance by the American region in terms of size of mutual funds, which is attributable to factors such as the availability of capital and the number or size of market players (financial institutions and client base).

Figure 5 - Percent of Worldwide Mutual Fund Assets by Type of Fund, 2014



Source: Investment Company Institute (2015:4)

Figure 5 indicates that at the end of the fourth quarter of 2014, 44% of worldwide mutual fund assets were held in equity funds. The asset share of bond funds was 24% and the asset share of balanced/mixed funds was 13%. Money market fund assets represented 14% of the worldwide total. This reflects the dominance of equity fund in the market.

South Africa’s Investment Management industry is a vibrant, sophisticated environment, with investors having access to a wide variety of investment products, ranging from traditional to alternative strategies (University of Cape Town 2014: 28). The wake of the recent financial crisis has seen a proliferation of new investment products, as portfolio managers attempt to respond to the new volatile financial market environment. As a result, the local industry has also undergone a significant change, which has presented both restraints to and opportunities for growth (SARB 2014). The global recovery remained uneven and fragile for South Africa in 2014, with monetary policies in key economies continuing to support economic activity despite the gradual downscaling of quantitative easing in the United States (SARB 2014).

According to the National Treasury (2011), in relation to the size of the economy, South Africa has one of the largest pension fund industries in the world, with nine million members and assets in excess of R2 trillion. Globally and locally, pension funds are also important institutional investors. They pool funds from both employers and employees, with the aim of providing retirees and their beneficiaries with income upon retirement, death or disability of a member. This guards against poverty in old age and reduces the potential dependency on the government.

Financial markets are often characterized by uncertainties such as recessions, depressions and changing political environments. In terms of markets where demand and supply determine the trading in that market, the characteristics of financial markets where the primary product is money are unique (Van der Berg 2002: 8). Because of the unique characteristics in financial markets, certain risks exist which do not exist in other markets and which must be managed. The management of these financial risks by means of derivatives products has resulted in an evolution of financial markets in the past few years.

South African private equity activity is a critical part of investment management business for asset managers. According to the latest figures published in the KPMG/SAVCA Private Equity Survey conducted in 2013, deal flow trends in the South African private equity market over the last decade have followed a similar track to those in Europe and North America, with activity levels rising to a peak in 2007 before falling sharply thereafter (SAVCA 2013: 2-3). In total, South Africa's private equity industry, including both government and private funds, had R171.1 billion in funds under management as at 31 December 2014, an increase from R169.3 billion since 31 December 2013 (KPMG-SAVCA 2015: 07).

2.4 Asset Management Industry contributions to employment creation

South Africa's main social problems remain its extremely high income inequality and youth unemployment, but inadequate access to healthcare and a poor social safety net are also contributing to a below par result on the social sustainability dimension (WEF 2015: 71). The social effects of unemployment and employment losses are hard to calculate, but it has been estimated that the dependency ratio of those employed is 1:5 (DTI & Deloitte 2015: 43).

According to Sutton & Beth (2007: 9), in many developing countries such as South Africa and Nigeria, small and medium-enterprises (SMEs) with fewer than 50 employees constitute 95% of all businesses. The contribution of SMEs in these developing countries to GDP and employment is far less than their developed country counterpart: thus 17% and 30%, respectively, compared with 50% and 60% in developed countries such as the United Kingdom and Germany, respectively. The comparison is also relevant in the South African asset management industry, where most of the small and medium enterprises struggle to grow at a faster rate.

According to the Quarterly Labour Force Survey (QLFS) 2016 conducted by Statistics South Africa, the number of persons employed in South Africa increased by 171 000 from the second quarter of 2015 to the third quarter, raising the total level of employment to roughly 15.83 million. Employment in the finance, insurance, real-estate and business services sector decreased marginally in the second quarter of 2015, following two consecutive quarters of employment gains (SARB 2014a: 18).

At the macro-economy level, the financial sector enables economic growth, job creation, the building of vital infrastructure and sustainable development for South Africa (National Treasury 2011). Job creation in the formal sector of the economy failed to keep pace with the rate of economic growth in 2013. The government has led job creation since the recession while the private sector shed jobs, but it now wants to curb the growth of its

wage bill (Maswanganyi 2014: 02). South Africa needs faster and more inclusive economic growth to reduce unemployment, poverty and inequality (National Treasury 2014). However faster growth over the medium term requires bold decisions to change the structure of the economy to increase the level of competition and innovation, raise the level of savings, reduce the cost of transport and communication, and improve regional trade and increase integration into the global supply chains (National Treasury 2014). The financial sector plays a significant role in stimulating savings and investment.

The South African Reserve Bank (2014a) shows that employment trends reflected the generally subdued growth in economic activity. Enterprise surveyed employment in the formal non-agricultural sector (i.e. trade and finance) rose somewhat over the most recently available four quarters to the first quarter of 2014, but most of the job creation took place in the public sector. Employment increased by 203 000 jobs in the fourth quarter of 2014, largely driven by the formal sector, which created 68 000 jobs, of which 48 000 were recorded by the finance and trade, with the informal sector contributing 41 000 jobs. This resulted in the unemployment rate decreasing by 1.1%, from 25.4% to 24.3% in the fourth quarter of 2014 (DTI 2015: 21)

The QLFS is a household-based sample survey conducted by Statistics South Africa (Stats SA). It collects data on the labour market activities of individuals aged 15 years and above who live in South Africa. However, this report only covers labour market activities of persons aged 15 to 64 years. According to the Quarterly Labour Force Survey, since the low-point of the 2009 recession, employment has increased by approximately 1.3 million. However, unemployment of 24% of the work force is still far too high (Gordhan 2014).

Table 2 - Employment by industry

Industry	Apr-Jun 2013	Jan-Mar 2014	Apr-Jun 2014	Qtr-qtr change	Year-on-year change	Qtr-qtr change	Year-on year change
	Thousand					Percent	
Total	**14 692**	**15 055**	**15 094**	**39**	**403**	**0,3**	**2,7**
Agriculture	742	709	670	-39	-73	-5,5	-9,8
Mining	403	424	419	-5	16	-1,2	3,9
Manufacturing	1 838	1 804	1 745	-60	-93	-3,3	-5,1
Utilities	123	130	118	-11	-5	-8,8	-3,8
Construction	1 149	1 199	1 182	-18	32	-1,5	2,8
Trade	3 087	3 186	3 179	-8	92	-0,2	3,0
Transport	897	895	947	52	50	5,9	5,6
Finance and other business services	1 967	2 045	2 012	-34	45	-1,7	2,3
Community and social services	3 266	3 428	3 531	103	265	3,0	8,1
Private households	1 215	1 231	1 290	60	75	4,9	6,2

Source: Adapted from Statistics South Africa Quarterly Labour Force Survey, 2nd Quarter 2014

Table 2 shows that between Q1: 2014 and Q2: 2014 the number of employed people declined in seven of the ten industries. Compared to a year ago; in Q2: 2014, employment increased by 403 000 largely due to increases observed in the trade sector as well as finance and other business sector. This is reflective of the significance of the financial sector towards employment creation. For 2014, high unemployment was reflected in low savings rates and high lapses for insurance policies, or consumers cashing in their savings to invest in unregulated entities (FSB 2015: 9).

According to the South African Venture Capital and Private Equity Association Survey (2013: 3-4), investee companies create employment, with the number of staff employed

by participants growing by around 40% over the 2 year period ending 31 March 2013. Private equity investors play an invaluable role in helping their investee companies build more robust structures.

2.5 Asset Management Industry contributions to gross domestic product (GDP)

In 2014, the global economy witnessed uneven growth in advanced, emerging and developing economies due to a number of reasons, including the geopolitical tensions in Russia, global weaker demand, the technical recession in Japan and weaker investments experienced by China and the Euro regions. Global growth moderated to an annualised rate of 3.2% in Q4:2014, compared to 4.6% in the third quarter of 2014 (DTI 2015: 20).

Sub-Saharan Africa was one of the world's fastest growing regions in 2012, with investment activity as a major driving force (Industrial Development Corporation 2013: 1-2). South Africa accounts for just under a fifth of Africa's GDP, 0.7% of world GDP and less than 2% of global assets under management (Towers Watson 2014: 20-22). South Africa's economy grew by 1.3% in 2015, down from 1.5% in 2014, 2.2% in 2013 and 2.5% in 2012 (Statistics South Africa 2016). Yet despite its modest global standing, South Africa has a highly developed financial services industry, when set against global benchmarks (Towers Watson 2014: 20-22).

The global economic outlook remains unsteady – some advanced economies have returned to growth, others continue to lag (Gordhan 2014). The slowdown in quantitative easing by the Federal Reserve has caused further uncertainty to financial markets, currency volatility and capital outflows from emerging markets. South Africa's economy has continued to grow, but more slowly than projected a year ago (Gordhan 2014).

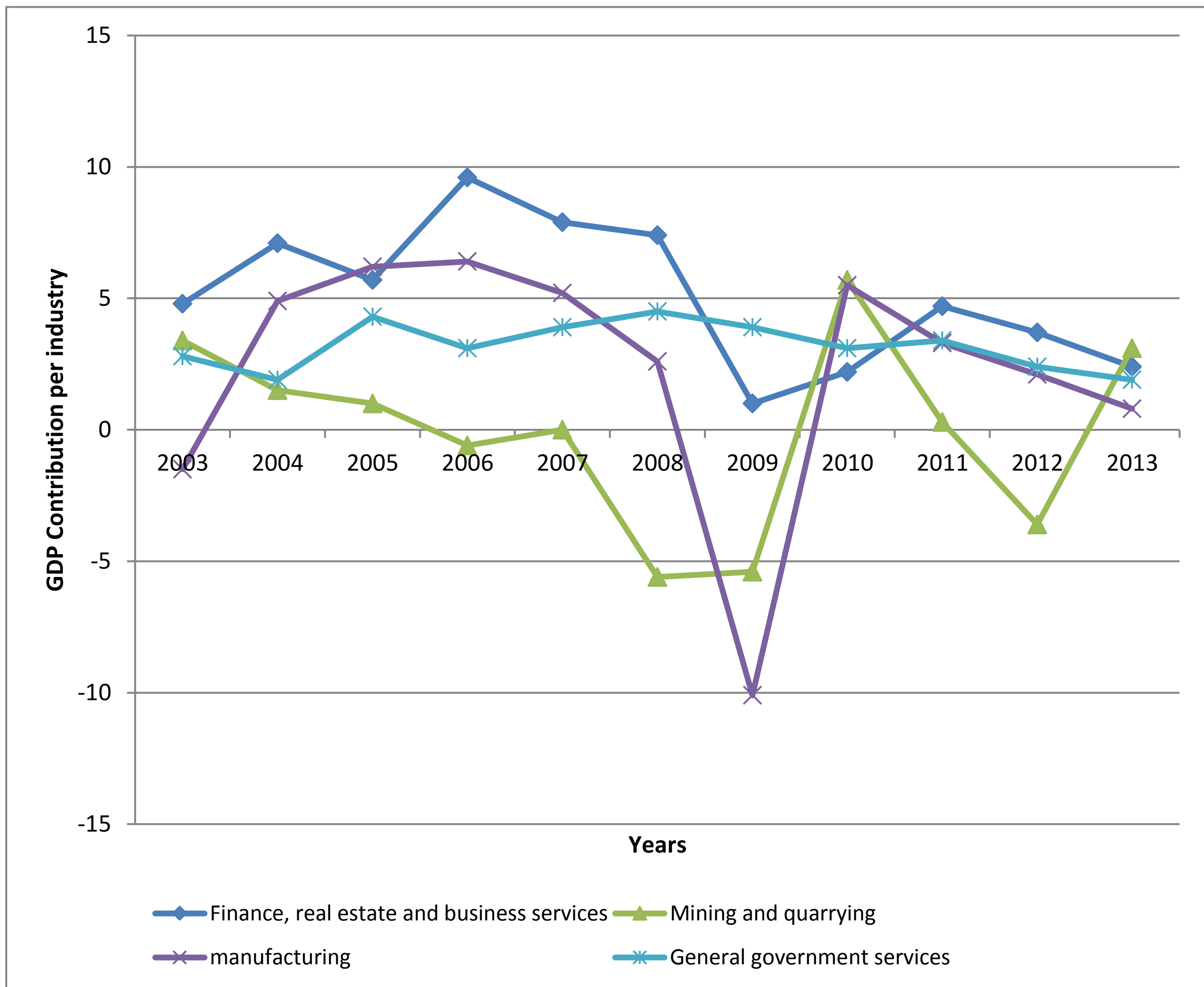
Table 3 - Gross Domestic Product, Contribution by Sector

No	Sector	Percentage contribution
1	Finance, including real estate and business activities	22%
2	Government services	17%
3	Wholesale, retail	15%
4	Manufacturing	14%
5	Transport	9%
6	Mining	8%
7	Personal services	6%
10	Construction	4%
11	Agriculture	3%
12	Electricity, gas and water	2%

Source: Adapted from PWC Market Research Centre based on Statistics South Africa data (2015: 20)

South Africa has a sophisticated business environment with low barriers to entry, strong state institutions, and an economy that is diversifying to increase the presence of services (PWC 2015: 21). This process of diversification can be seen in the decomposition of South Africa's GDP by sector. Table 3 shows that the largest value added comes from finance (including real estate and business services) which accounted for 22% of total value added at year ended 2014 (PWC 2015). Established in 1887, the JSE is the largest exchange in Africa, with a market capitalization representing 288% of GDP at the end of 2014 and almost 400 companies listed (PWC 2015: 21).

Figure 6 - Annual value added by industry and GDP at constant 2005 prices (R mil)



Source: Adapted from Statistics South Africa GDP, 1st Quarter 2014

Figure 6 shows value added by industry at constant 2005 prices and reflects that the economic activity in finance, real estate and business services reflected positive growth of 2.0% during the last quarter of 2013, due to increased activities in the equity, bond and other financial markets in auxiliary activities. All the sectors show constant positive growth in GDP contribution for the period 2003 to 2013, save for the manufacturing and mining sector which experienced negative growth during 2007-2009 period, which could be attributable to the effects of the global economic crisis. The real gross domestic product

at market prices decreased by 0.6% quarter-on-quarter, seasonally adjusted and annualized. According to Statistics South Africa (2014), the adjusted real GDP at market prices had increased by 1.6% year-on-year.

According to the South African Reserve Bank (2014a), following the negative growth rate recorded in the first quarter of 2014, the South African economy escaped a further contraction in the second quarter as real domestic production rose at an annualized rate of 0.6%. This barely positive growth rate was extremely disappointing given the country's development needs, and was mainly brought about by the drawn-out industrial action in the platinum-mining subsector which started on 23 January 2014 and only came to an end five months later.

Table 4 - Real Gross Domestic Product

Percentage change at seasonally adjusted annualised rates							
Sector	2013					2014	
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr
1.Primary sector (Agriculture and mining)	7,5	-4,7	8,9	12,8	2,9	-17,2	-5,1
2. Secondary sector (Manufacturing)	-5,9	9,6	-4,5	9,2	1,0	-2,7	-0,9
3.Tertiary sector (Finance, insurance, real estate and business service sector)	2,0	2,2	1,3	1,5	2,0	1,8	1,8
4.Non-primary sector	*0,0*	*4,0*	*-0,1*	*3,3*	*1,8*	*0,7*	*1,2*
5.Total	0,8	3,2	0,7	3,8	1,9	-0,6	0,6

Source: SARB Quarterly Bulletin, September 2014

Table 4 shows that growth in the real value added by the finance, insurance, real-estate and business services sector slowed to an annualised rate of 1,8 per cent in the second quarter of 2014 following an increase of 2,0 per cent in the first quarter. The somewhat slower growth could be explained by reduced activity in the domestic securities market as trading activity on the JSE Limited (JSE) lost some momentum. The real output of the banking sector, however, increased in the second quarter of 2014 (SARB 2014a).

2.6 Conclusion

The South African financial markets have emerged from political and economic challenges that have faced the country over the last decade, as world class in the breadth and depth of many of their activities. This places South Africa's financial system in the premier division of developing countries and has led many commentators to draw parallels between our system and that of the more developed economies of the world (SARB 2003).

The asset management industry plays a crucial role in economic growth and financial stability (Carvajal & Elliott 2007: 4). It is evident from the discussions above that the financial sector plays a critical role in expanding economic opportunity, as it enables economic growth and job creation for South Africa. There is a positive relationship between the growth in the country's GDP and the AUM in the asset management industry. Economic growth boosts economic activity such as employment creation, and in turn results in increase in capital and investments in the asset management industry. Thus if the economy grows at a faster rate, we are likely to see the AUM in the asset management industry also growing at an accelerated rate.

According to the South African Reserve Bank (2014a: 2-3) global financial markets remain dominated by expectations of changes in monetary policy in the advanced economies, amid concerns that the current low interest rate and low volatility environment

may encourage excessive risk taking and asset price bubbles. Survive, sustain and grow, in a nutshell, describes the global wealth and asset management industry from the inception of the global financial crisis in 2008 through today (Ernest and Young 2014: 1).

Although conclusions must be stated hesitantly and with ample qualifications, the preponderance of theoretical reasoning and empirical evidence suggests a positive, first-order relationship between financial development and economic growth. A growing body of work would push even most skeptics toward the belief that the development of financial markets and institutions is a critical and inextricable part of the growth process and away from the view that the financial system is an inconsequential side show, responding passively to economic growth and industrialization. There is even evidence that the level of financial development is a good predictor of future rates of economic growth, capital accumulation, and technological change (Levine 1997: 688-726).

Chapter Three: The regulatory regime affecting the asset management industry

3.1 Introduction

Whilst Chapter 2 placed emphasis on the socio-economic importance of the asset management industry, Chapter 3 seeks to investigate whether the current regulatory universe is adequate and justified. Thus, we will review the rationale and objectives of regulation in the asset management industry, particularly in relation to mitigating the risk of corporate or market failures and misappropriation of clients' investments. According to the Financial Services Board (FSB), the financial sector has contributed to South Africa's institutions ranking among the world's best (FSB 2013: 4). While market conduct regulations have been strengthened, mandates of the FSB, National Credit Regulator and the National Consumer Commission still overlap and enforcement remains a major concern (World Bank 2013: 28).

The regulations aim to ensure that benefits such as stability, consumer protection, efficiency and competition (Sprong 2000: 43) will provide a positive contribution to the economy and the consumers of financial services. All legislations, which include the Act of Parliament and Subordinate legislation, are subject to a comprehensive process of consultation with industry associations, consumer organisations and other stakeholders (van Wyk, Botha & Goodspeed 2012: 112- 113).

According to the World Economic Forum Global Competitiveness Report (2013: 325), South Africa was ranked number one out of 144 countries in terms of the regulation of securities exchange. The factors that are considered include the structure and effectiveness of the regulator of securities exchanges, including its enforcement program and activities, which aims to ensure smooth functioning of trading and clearing and settlement mechanisms that will prevent market disruption and foster investor confidence (WEF 2013: 325-354).

Similar to the regulatory revolution that reshaped the airline and telecommunication industries in the 1980s and 1990s and rewrote the list of winners, new compliance requirements will likely be a game changer for asset managers (Ernest and Young 2015: 8). Core functionalities of most asset management firms encompass business development, portfolio management, client service, and more recently, compliance.

Promoting competition, ensuring market integrity, including systematic or macro credit-risk protections, and managing "public-good"-type externalities cover the broad potential roles for regulation and other government activities in improving the economic performance of financial intermediaries. The financial innovation is the engine driving the financial system toward its goal of greater economic efficiency. Innovation in financial intermediation improves efficiency by completing markets, lowering transaction costs, and reducing agency costs (Merton 1995: 36).

According to Frankel (2009: 4-6) the 2008-2009 economic crash, combining the enormous bubble of sub-prime mortgage-backed securities with the failure of the auctions for “auction rate securities” and the mammoth derivative markets, has shaken not only the financial system and the economy of the United States but the economies of other countries as well. The financial markets have functioned poorly, and some not at all. Post the economic crisis, there have been voices calling for more and stricter regulation. These voices raise serious doubts about the efficiency of the informed markets, especially in light of the complexity of the current financial instruments and institutions and the inability to publicize what is truly important to understand in the securities that are offered and the trading that is taking place (Frankel 2009: 17).

3.2 The rationale and objectives of regulation of the asset management industry

The global economy is emerging from the most serious financial crisis since the Great Depression of the 1930s. At its roots were the twin problems of global macroeconomic

imbalances and inadequate financial sector regulation (National Treasury 2011: 3-8). Where the macroeconomic causes of financial crises usually affect markets, the microeconomic causes of financial distress are virtually, as a rule, related to institutions (Falkena *et al* 2001: 86).

All the instruments of financial regulation are ultimately aligned to a specific regulatory target and goal (Falkena *et al* 2001). The regulation of asset management aims to ensure professional management and adequate disclosure of investments to the investors (Carvajal & Elliott 2007: 6). According to the FAIS Act (2002: 3-15), the purpose of regulation of asset managers is to protect the consumers of financial products and to raise and maintain the professional standard in the financial services industry.

Table 5 - Regulatory matrix- Alignment of instruments to regulatory objectives

Regulatory matrix- Alignment of regulatory instruments to regulatory goals and objectives																		
Regulatory ultimate objectives	Systemic stability						Institutional safety and soundness					Consumer protection						
Regulatory intermediate goals / Regulatory regime and its instruments	Competitive market infrastructure	Acceptable maturity and currency mismatches	Acceptable cross market exposures	Sufficient market liquidity	Securities markets as alternative to intermediation	Regulatory effectiveness, efficiency and economy	Proper risk assessment	Proper institutional structure	Fit and proper directors and staff	Global institutional competitiveness	Competitive neutrality	Integrity and fairness	Competence	Adequate product/ service competitiveness	Transparency and disclosure	Access to retail financial services	Protection of retail funds	Retail compensation schemes
Official rules and regulations																		
1.1 Entry and standard constraints	x			x	x		x	x	x		x	x	x	x	x		x	x
1.2 Ownership constraints							x											
1.3 Functional activity constraints							x		x		x							
1.4Jurisdictional constraints		x	x				x											
1.5 Pricing constraints												x						
1.6 Operational constraints					x		x		x	x	x	x	x	x	x	x	x	x
1.7 Official monitoring and supervision	x		x				x	x	x			x	x		x		x	x
1.8 Intervention and sanctions	x	x	x				x	x									x	x
1.9 Incentive contracts and structures					x	x	x	x		x	x	x		x	x		x	

1.10 Market monitoring and discipline	x		x	x	x		x	x	x	x	x	x	x	x	x	x	x	x
1.11 Corporate governance	x			x	x		x	x	x	x		x			x			
1.12 Discipline/ accountability of regulators						x				x				x				

Source: Falkena, Bamber, Llewellyn & Store (2001: 43)

Table 5 indicates that all the instruments of a financial regulation are ultimately aligned to a specific regulatory target and goal. In terms of table 5, an X means that the specific instruments within a component of the regulatory regime are aligned to the intermediate target and thus support the particular ultimate objective of regulation. For instance, some policy instruments that support market efficiency may do so at the cost of consumer protection or may threaten to destabilize the financial system.

As is evident from table 5, a number of policy instruments can usually be aligned to a specific intermediate goal and target. An integrated target-instrument approach to financial regulation means that both the advantages and disadvantages of every regulatory instrument have to be taken into consideration before being employed. Therefore the Xs in table 5 do not indicate that a specific instrument will always be the appropriate one to address a specific target(s), but rather that it can be aligned (however defectively) to a specific target(s).

As shown in table 5 there are many other instruments aligned to reduce systematic risks and accordingly in terms of an integrated target-instrument approach these other instruments, rather than price fixing, should be used to reduce systematic risk. As regulatory instruments generally constrain the activities of market participants, the ideal should be to use the minimum number of instruments to obtain the maximum effect on the intermediate goals. Regulatory constraints are justified in that they aim to reduce

market failure, i.e. asymmetric information (resulting in for instance, insider trading), monopoly powers and externalities.

3.2.1 Regulation is a means to address market failure

Regulation by the State is also seen as a means by which the State addresses the side effects of market failure (McAleese 2004). Market failure refers to the occurrence where the market system is unable to achieve an efficient allocation of resources. It has been suggested that market failures may be more pronounced in developing countries and that the case for increased regulation in developing countries is therefore stronger (Kay and Vickers 1998: 286-343).

Market failure was used to legitimize government intervention in private sector activities in developing countries between 1960 and 1980 (Jalilian, Kirkpatrick & Parker 2007). As developed countries celebrated the success of liberalization programmes and evidence of failures in state-led economies mounted, regulation was redefined. In this context it was estimated that excessive regulation might impact negatively on GDP (Koedijk and Kremers 1996: 445-448). Deregulation was widely adopted to reduce the regulatory burden on market economies. The wave of privatization that spread through the developing world during the 1990's resulted in the establishment of numerous regulatory bodies to oversee and supervise functions that were previously under state control. This shift has led to the current regulatory state (Jalilian *et al* 2007: 87-103).

Regulation has accordingly seen a shift from the model of an interventionist state in the 1960's to a deregulation model, to the current focus on the regulatory state. The regulatory state model aims to adopt a more balanced approach by using government regulation only where significant market failure exists (Kay and Vickers 1988: 286-343). The corporate failures worldwide in the 1960's have triggered a new wave of regulation as policy makers attempt to achieve a balance between consumer protection and the establishment of effective regulatory structures.

Market regulators should follow a process similar to bank regulation, regarding ongoing examinations. They should continuously examine financial market intermediaries and large issuers. Banking examination can offer a model. In large banks examiners reside more or less continuously for a number of years. The same system can apply to market intermediaries such as the large broker-dealers, large mutual fund advisers-managers, and the large pension funds that are self-managed (Frankel 2009: 20).

Frankel (2009: 20-22) argues that the examinations and regulation by regulators should focus on the following:

- Intensify and become more frequent when market prices rise rather than when markets crash and prices fall;
- Entities and institutions which are too large to fail. The obvious reason for these examinations is to help predict and prevent the failure of such enterprises that may affect the financial system as a whole;
- Financial entities that are highly leveraged. Such entities, especially if they are sufficiently large, can pose a threat to the financial system;
- Entities whose share prices rise without fluctuations. The reason for these examinations is that more often than not performance that is "too good to be true," is not true; and
- Cover corporations and entities that have received exemptions from the law. The reason for this examination-focus is that by definition, freedom from legal constraints may be used well or abused. The legal constraints were imposed because the prohibited activities could bring about undesirable social results.

According to Merton (1995: 38) the feasible set of sustainable regulatory policies is increasingly endogenously determined as the time horizon lengthens. Therefore, regulatory change has a limited long-run role as an exogenous force for financial innovation and non-transitory structural changes in financial intermediation. Vass (2008: 1) caution that the two events, increased regulation, and increased government

intervention, occurring at the same time, will throttle the innovation economic forces that unleash economic growth.

3.2.2 Measures for assessing regulatory quality

According to Kay and Vickers (1988) there exist a strong causal link between regulatory quality and economic performance. The effectiveness of regulatory institutions is an important determinant of how well a market functions. The effectiveness of regulation is not only concerned with the technical design of regulation- it is also concerned with and depends on the quality of the supporting regulatory institutions and their capacity to police the enforcement of the relevant regulations. The quality of regulatory governance accordingly affects regulatory outcomes that in turn impact on economic growth.

There are two criteria for assessing regulatory quality- the quality of the outcomes and processes of regulation (Jalilian *et al* 2007). The former can be assessed against effectiveness and efficiency whilst the latter can be assessed against a balance of accountability, transparency and consistency.

3.2.2.1 Effectiveness and efficiency

Effective regulation achieves the goals set down by the state for regulatory authority. In developing countries these goals are mostly concerned with economic efficiency, the promotion of sustainable development and poverty reduction. Efficient regulation achieves the goals set down by the government but does so at minimum economic cost (Kirkpatrick, Parker and Zhang 2005). The economic cost of regulation consists firstly of the internal cost of administering the regulatory system, which is carried by the state and reflected in the national budget. Secondly, it consists of the external cost of business complying with regulation, which is carried by consumers and producers in terms of economic cost of conforming with and of evading or avoiding regulation.

Regulation may accordingly be efficient because it is relatively inexpensive to comply with and to enforce. The relevant regulation may however be completely ineffective in that it fails to achieve the goals set down by Parliament. Parker (1999) describes an effective regulatory system as one that meets customer and shareholder needs, maintains efficiency and investment incentives, minimizes inconsistency and provides management with maximum freedom to manage their business at a minimum of compliance costs.

To support the intermediate goal of regulatory effectiveness, efficiency and the economy the following regulatory targets can be identified (Falkena, Bamber, Llewellyn & Store 2001):

- Establish co-ordination agreements among domestic regulatory agencies. Unless such agreements are in place, the authorities may be confronted with regulatory gaps in the supervision of complex financial groups;
- Establish harmonization agreements between home and host regulators. Without harmonization in this area it will be difficult to effectively supervise global financial conglomerates and hedge funds in offshore financial centres;
- Stipulate regulatory cost-benefit analysis. The danger of over-regulation can only be addressed if the authorities do detailed cost-benefit analysis;
- Establish a regulatory audit agency. Such an agency would go a long way towards ensuring that appropriate accountability takes place on the part of the regulators; and
- Establish ratings of national regulatory agencies. International bodies, like the IMF or the World Bank, could perform this task.

3.2.2.2 Accountability, transparency and consistency

According to Jalilian *et al* (2007) and Parker (1999) accountability relates to an observance by regulatory agencies of the rules of due process and engaging in proper consultation when arriving at decisions. Accountability requires that the regulatory agencies operate within their legal powers and are accountable for their actions. At the

right of accountability lies the right to appeal- recourse from a regulatory commission to the courts to review the regulator's decisions (Parker 1999).

Transparency requires that regulatory agencies reach decisions in a way that is revealed and communicated to stakeholders in a consistent and clear manner. Inconsistency undermines public confidence in the regulatory system and creates uncertainty for investors (Kay and Vickers 1988). Inconsistent regulation will discourage investment and stymie the development of competition in the industry.

Falkena *et al* (2001) maintain that in order to support the intermediate goal of transparency and disclosure, the following regulatory targets can be identified:

- Adherence to an international code of conduct. Although every nation may have different ideas about what appropriate disclosures means, it is helpful for international investors if at least the minimum standards are met in this respect;
- Establish government - defined benchmarks for better consumer information. Often consumers find it difficult to compare prices because of lack of standardization. Officially agreed benchmarks, including the cost of a "basic bank account", will better address consumer grievances. The regulatory authorities, including the industry associations, can do more to enhance the supply of competitive information, *inter alia* through the internet; and
- Inform the financial press. The regulatory authorities should establish a practical, mutually effective, working relationship with senior financial journalists in order to promote better communication with the public at large.

Regulation is accordingly a balancing act that seeks to advance the interests of consumers, competitors and investors whilst simultaneously balancing the industry, environment and social needs. Regulation accordingly lacks quality when regulators act in a manner that is contrary to the measures highlighted above. This will occur when the interests of all stakeholders are not balanced but where the interests of certain stakeholders are placed above those of others.

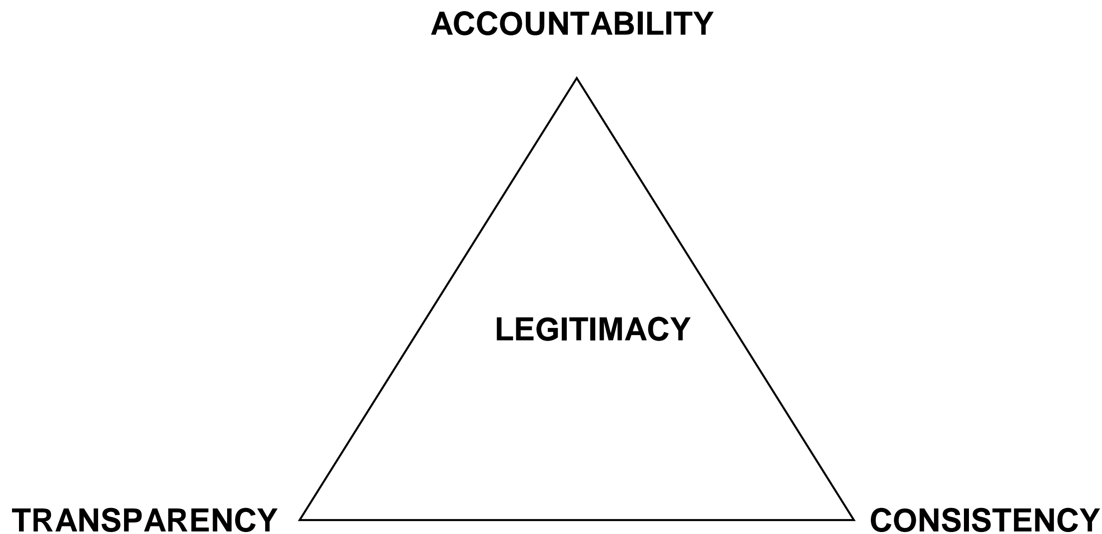
3.2.2.3 Legitimacy and Independence of regulators

Coupled with the consistent behavior of regulators is the independence of regulators. Political intervention undermines regulatory consistency, as politicians may be prone to manipulate the regulatory process for short-term political gain. It is accordingly crucial that regulators remain independent. It is suggested that balanced, strong regulatory institutions, independent from political intervention is a strong determinant of improved economic growth (Kirkpatrick, Parker and Zhang 2005).

“Independent” should not be misunderstood however- a regulator that is completely autonomous and with no public accountability would not be acceptable. A proper system of democratic accountability should exist and in this sense “independent regulator” is intended to convey a high degree of separation from political or government intervention but not complete independence from political scrutiny (Parker 1999). According to Parker (1999) the overriding objective of an independent regulator can invest with confidence that expected returns on capital will not be compromised by political intervention.

Jalilian *et al* (2007: 83-103), like Parker (1999), also believes that a well-functioning regulatory system is one that balances accountability, transparency and consistency. When these three characteristics are present, legitimacy arises- public confidence that the regulatory system achieves a balance between the needs of the company and those of its shareholders. In addition, legitimacy will arise when the regulatory system maintains efficiency and investment incentives and minimizes regulatory uncertainty and risk.This relationship can be illustrated by way of the diagram in Figure 7 below.

Figure 7 - Model of a well-functioning regulatory system (Parker 1999: 84)



3.3 The regulatory regime and universe in the asset management industry

There are a number of Regulators that administer and play an oversight role in respect of relevant and applicable legislations in the financial services sector. The legislations hereunder are primarily dominant in terms of the extent of regulation of financial markets and instruments and the time and resources required to mitigate the risk of non-compliance. Thus, it is imperative that a thorough investigation is conducted by assessing the implications of the said legislations. Below, we will look at the Regulators and legislations that affect asset managers, through aligning the legislations to the Regulator that administers them.

Moreover, it is important to highlight that South Africa has adopted and is currently in the process of implementation of the Twin Peaks regulatory model. The objectives of the Twin Peaks regulatory model is to achieve increased regulatory coverage, minimising potential for regulatory gaps, ensuring that regulatory laws are complete, harmonised, integrated, proportionate and dedicated. The aim is also to ensure that equal emphasis is placed on monitoring stability, prudential and conduct risks in financial sector, ensuring

more efficient use of supervisory capacity and strengthen risk-based approach as well as strong and swift action for contraventions (Financial Sector Regulation Bill 2015: 22).

The Twin Peaks establishes two regulatory authorities, namely Prudential Authority (PA), which will focus on enhanced oversight of micro-prudential regulation for banks, insurers, financial markets, including special focus on conglomerates, while Financial Sector Conduct Authority (FSCA), is aimed at ensuring increased focus on outcomes, especially fair customer treatment. The PA will fall under the SARB, while the FSB will be incorporated under the FSCA.

3.3.1 The Financial Services Board

The FSB is a unique independent institution established by statute to oversee the South African Non-Banking Financial Services Industry in the public interest. The FSB's mission is to promote the fair treatment of consumers' financial services and products, financial soundness of financial institutions, systemic stability of financial services industries and the integrity of financial markets and institutions (FSB 2014a).

3.3.1.1 Financial Advisory and Intermediary Services Act, 2002 (FAIS Act)

The FAIS Act provides for regulation of various categories of Financial Services Providers, namely:

- Category I: FSPs providing financial advice
- Category II: Discretionary Financial Services Providers
- Category IIA: Hedge Funds Managers
- Category III: Administrative Financial Service Providers
- Category IV: Friendly Society Benefits

The FAIS Act regulates the rendering of financial services in respect of financial products such as insurance, pension funds, bank deposits, forex investment business,

collective investment schemes as well as securities and instruments, including equities, bonds, money markets, derivatives, warrants, debentures and securitized debt.

The Financial Services Board (2015: 19-26), in its annual report, indicates that financial advisory and intermediary services are provided by around 11 000 individual financial service providers, ranging from large banks and insurers to small sole proprietors, and monitored by over 4 000 compliance officers. Over 600 of these entities are licensed to manage assets worth R7.2 trillion, largely for individuals and companies of all sizes.

The FAIS Act provides for the Fit and Proper requirements that should be met and complied with by FSPs, its Key Individuals and Representatives, as follows:

- Financial Soundness- The FSP must be financially sound, thus its assets should exceed its liabilities
- Operational Ability- The FSP must have facilities and equipment to be able to render the financial services
- Competency Requirements- The Key Individuals and Representatives of the FSP must meet certain qualifications and minimum experience requirements, depending on the nature of financial services rendered.
- Regulatory Examinations - The Key Individuals and Representatives are further required to complete Level 1 and Level 2 regulatory examinations, which relate to the legislative requirements and financial product knowledge, respectively.
- Personal character of honesty and integrity- The Key Individuals and Representatives of the FSP must demonstrate that they are trustworthy, such that they could be entrusted with rendering financial advice to clients and managing of clients' funds.
- Continuous Professional Development (CDP) – The Key Individuals and Representatives are required to attend workshops and training, on a continuous basis, that is considered relevant within the financial services industry.

Table 6 - Impact of regulating individuals and instruments by minimum requirements

Favourable	Unfavourable
• Encourages the employment of fit and proper individuals, which reduces systematic risks • Encourages ethical standards being maintained • Supports market liquidity, as trades are executed by suitable persons • Can be a cost-effective, flexible and practitioner-based way of regulation • Enhances public confidence	• Imposes an entry barrier to trade • May result in a de facto restriction • May give false security to consumers, as the usually minimum level of competence is examined only once and not on a continuous basis

Source: Falkena *et al* (2001: 45)

Table 6 provides the advantages and disadvantages of imposing the minimum standard requirements for financial institutions operating in the financial markets. In my view, it is evident that the benefits of regulating the financial individuals and instruments outweighs the disadvantages. Following the introduction of the FAIS Act on 30 September 2004, the market conduct of FSPs and its representatives has improved significantly. The above FAIS fit and proper requirements have gone a long way in ensuring that its primary objectives of consumer protection and professionalization of the financial services industry are achieved and realized, to a large extent.

The FSB has further introduced a regulatory and supervisory approach called Treating Customers Fairly (TCF) that Category II Financial Services Providers (FSPs), amongst other categories of financial institutions, are required to comply with. TCF is an outcome based regulatory and supervisory approach designed to ensure that specific, clearly articulated fairness outcomes for financial services consumers are delivered by regulated

financial firms. According to the FSB TCF Roadmap (2011: 5-10), regulated financial institutions are expected to demonstrate to the FSB that they deliver the following six TCF Outcomes to their customers throughout the product life cycle:

a. Culture and Governance : Customers can be confident they are dealing with firms where TCF is central to the corporate culture
b. Products and Services Design: Products and services marketed and sold in the retail market are designed to meet the needs of identified customer groups and are targeted accordingly
c. Disclosures to Clients: Customers are provided with clear information and kept appropriately informed before, during and after point of sale
d. Suitability of Customer Advice: Where advice is given, it is suitable and takes account of customer circumstances;
e. Performance and Service against Expectations: Products perform as firms have led customers to expect, and service is of an acceptable standard and as they have been led to expect.
f. Changing Products, Switching Providers and Complaints Handling: Customers do not face unreasonable post-sale barriers imposed by FSPs to change product, switch providers, submit a claim or make a complaint.

Overall, the TCF principle is a great initiative and regulatory tool to measure the fairness of treatment of customers by the FSPs, with a view to ensure that quality client service is maintained even post the sale of products. However, the TCF Outcomes are not equally relevant to all types of FSPs. For example, Outcome b, d and f as described above are not that relevant to asset managers (FSPs) that predominantly deal with institutional clients. These outcomes are more geared towards Financial Advisors dealing with retail clients.

The FSB conducted a self-assessment study amongst asset managers in 2014 to establish the readiness and level of implementation of TCF Outcomes. The asset

managers rated themselves highest in terms of the quality of information disclosed to clients, followed by the ease of changing products and providers, the fairness of disbursement practices and the extent to which products meet customer performance expectations (FSB 2014: 55-61).

From my observation, there is a need for enhanced monitoring and guidance by the FSB, especially towards other categories of FSPs and to some extent asset managers, to ensure that the TCF outcomes are adopted and embraced by senior management and board of directors of the FSPs so that the requirements are fully entrenched into the business processes. Thus a top-down approach is critical in order to realize complete and adequate implementation of the TCF requirements.

3.3.1.2 Financial Markets Act, 2012 (FMA)

The FMA provides for the regulation of financial markets. It further provides for the licensing and regulation of exchanges, central securities depositories, clearing houses and trade repositories; regulation and control of securities trading, clearing and settlement, and the custody and administration of securities; prohibit insider trading and other market abuses; and provide for the approval of nominees (Financial Markets Act 2012). The FSB and JSE are jointly responsible for administering and monitoring compliance with the FMA.

Table 7 - Listed financial instruments and their markets

Exchange / Listed Instruments	BESA	JSE	SAFEX
Equities		x	
Warrants on individual equities		x	
Bonds	X		
Futures			x
Options on futures			x

Source: Adapted from Falkena *et al* (2001:138)

Table 7 reflects that the Johannesburg Stock Exchange (JSE), as a self-regulatory organization, accepts the responsibility for regulating all trade in listed equities and warrants on individual equities. South African Futures Exchange (SAFEX) regulates all futures contracts (i.e. on commodities, currencies, equities and debt instruments) and options on these futures, while Bond Exchange of South Africa (BESA) regulates trade in listed bonds. All options in bonds are traded in the Over –the-Counter (OTC) market. The current regulatory structure may be attractive from a business efficiency point of view (Falkena *et al* 2001).

Table 8 - Impact of regulating financial instruments by minimum standards

Favourable	Unfavorable
• Reduces systematic risk by setting quality standards for instruments • Creates uniformity among classes of instruments and thus promotes competitive neutrality among issuers • Enhances the supply of information to investors by stipulating specific requirements (e.g. debenture prospectus) • Enhances investors' protection if an exchange supervises issuing and trading (for listed instruments only) • May enhance market liquidity if all instruments are traded on exchanges • Can be a cost-effective, flexible and practitioner-based way of regulation • Enhances consumer confidence	• May reduce market liquidity if regulatory restrictions become too expensive • Reduces consumer choice by eliminating poor, but also cheap, financial instruments • Reduces the supply of high risk/ high return instruments for portfolio diversification • May result in the playing field not being level between the issuers of listed and unlisted instruments • May be avoided by financial engineering • "Minimum" standards become "normal" standards

Source: Falkena *et al* (2001:48)

Table 8 provides a summary of the advantages and disadvantages of introducing the minimum standards in the regulation of financial instruments traded by asset managers. In light of the past experiences of corporate failures and misappropriation of clients investments, these minimum requirements provide the necessary protection to consumers and reduce systematic risk in the asset management industry.

In terms of the FMA, the asset managers are required to ensure that they develop and implement a Personal Account and Insider Trading policies (the policy) that must be

complied with by the employees, prior to dealing in listed equity securities for personal account. The policy should generally prohibit the asset managers and its employees from trading in listed securities on the basis of inside information (i.e. price sensitive information) relating to the investee company. Once the asset manager and its employees are privy to inside information with regard to any listed stock, such stock should be placed on the embargo list and no trade (buying or selling) should take place, until the inside information is made public.

Generally, personal trading account may only be opened under the auspices of Non-Discretionary Mandate, which refers to an investment agreement with the JSE Broker, under which the investing client is actively involved in the management of the portfolio and may direct the Broker when, where and how to invest. The JSE Broker may only act on the client's consent or instruction. Alternatively, employees may open personal trading account with Full Discretionary Mandates, which refers to investment agreement with the JSE Broker under which the portfolio is actively managed by the Broker, without any interference from the investing client. The terms of the full discretionary mandate, which prohibit any intervention or influence over the management of the portfolio, must at all times be adhered to.

3.3.1.3 Pension Funds Act, 1956 (Regulation 28)

The Pension Funds Act sets out to ensure that pension funds (institution and services) available legally to the South African public are conducted soundly and efficiently and that investors are fairly treated. It also aims to ensure the integrity of the market so that consumer confidence may be built and that there is fair business practices and proper means of handling complaints, dealing with unregistered entities, etc.

Regulation 28 prescribes maxima for various types of investment that may be made by a retirement fund (Pension Funds Act Regulation 28 2011). The aim of pension fund investment regulation is to ensure that the savings South Africans contribute towards their retirement are invested in a prudent manner that not only protects the pension fund

member, but is channeled in ways that support economic development and growth (National Treasury 2011).

Regulation 28 now better recognises and promotes the responsibility of funds and boards of trustees towards sound retirement fund investment (National Treasury 2011). It expands the allowance for debt issued by listed or regulated entities, thereby supporting a stronger corporate debt market and addressing the bank structural funding mismatch between short-term borrowing and long-term lending, while crucially still protecting retirement funds and their member's savings. The regulation better enables investment into unlisted and alternative assets to support economic development that may be funded through such capital-raising channels. Investment into Africa is likewise supported through providing for alternative ways of accessing this market in a responsible way. Importantly, the regulation continues to better align retirement fund regulation with other government policy objectives like socially responsible investing and transformation.

The adoption and implementation of Regulation 28 has contributed significantly in ensuring that the investment risk and exposure of client's funds, particularly the pension funds, is limited and properly managed. The asset manager therefore has a responsibility to ensure that the investment mandates that they sign with clients, detailing the asset classes (securities) and the percentage limits, is complied with, in efforts to realize the objective of protection of clients' investments.

3.3.2 The Financial Intelligence Centre

The Financial Intelligence Centre (FIC) is South Africa's national centre for the gathering, analysis and dissemination of financial intelligence (FIC 2014: 9). The purpose of the FIC is to establish and maintain an effective policy and compliance framework and operational capacity to oversee compliance and to provide high quality, timeous financial intelligence for use in the fight against crime, money laundering and terror financing in order for South

Africa to protect the integrity and stability of its financial system, develop economically and be a responsible global citizen.

The FIC had and continues to play a critical role with regard to combating of money laundering and terrorist financing. It has assisted in providing financial intelligence information to law enforcement agencies in efforts to fight the illicit flow of funds. There is however a need for better coordination of efforts between the FIC and the law enforcement agencies (National Prosecuting Authority (NPA), South African Revenue Service, etc). Thus, one of the areas of weakness in the current system is the lack of statistics on the success rate of prosecution by the NPA, as a result of suspicions or unusual transactions that were reported to the FIC by accountable institutions and subsequently escalated to the NPA for further investigation and prosecution.

3.3.2.1 Financial Intelligence Centre Act, 2001 (FICA)

FICA provides for the regulation of accountable institutions, such as Banks, Insurers, Credit Providers and FSPs. FICA seeks to criminalise money laundering and terror financing. It further provides for measures to be adopted by accountable institutions in order to comply with the legislation, such as identifications of clients prior to entering in to a business relationship or concluding a single transaction, and the reporting of suspicious and unusual transactions (STR) to the Financial Intelligence Centre (FIC).

The asset managers are accountable institutions as defined in Schedule 1 of FICA, by virtue of rendering financial services to clients under the FAIS Act. Given the complexity and huge amount of funds involved in the asset management industry, the asset managers may thus be utilized as a vehicle for money laundering and terror financing purposes by criminals. However, the fact that most transactions and flow of funds are done through electronic funds transfer (EFTs) with the banks, it makes it easier to trace the origin of the funds.

Notwithstanding the fact that the current provisions of FICA require identification and verification of clients by asset managers, which assists to a large extent in combating of money laundering, there is a weakness in that the legislation does not make it compulsory for clients to submit proof of the source of their funds or investments. However, FICA is currently being amended to make it compulsory for clients to provide proof of the origin and source of their funds. This will go a long way in enhancing the effectiveness of the controls by the accountable institutions, including the asset managers.

3.3.3 The Companies and Intellectual Properties Commission

The Companies and Intellectual Properties Commission (CIPC) is responsible for, *inter alia*, registration of companies. The CIPC's mandate to register companies suggests that it has a significant role to play in the economy as it determines entry or barrier of companies in terms of participation in envisaged type of business. The Companies Act, 71 of 2008, makes provision for establishment of a regulatory body, namely the Takeover Regulation Panel (TRP), for purposes of administration and monitoring of compliance with certain requirements.

The main function of the Takeover Regulation Panel (TRP) is to regulate certain mergers and acquisitions transactions defined in terms of section 201 of the Act as "affected transactions" involving certain public and private companies. In terms of section 221 of the Companies Act, the TRP is responsible to regulate affected transactions and offers (as defined in the Companies Act) and investigate complaints with respect to affected transactions and offers. The relevant provisions will be discussed under the Companies Act section below.

3.3.3.1 Companies Act, 2008

The Companies Act provides for, amongst others, the incorporation, registration, organization and management of companies; defines the relationships between companies and their respective shareholders or members and directors; equitable and efficient amalgamations, mergers and take-overs of companies; appropriate legal redress for investors and third parties with respect to companies; and establishment of the TRP to administer the legislative requirements with regard to companies.

The Companies Act further provides for the reporting of trades (purchases and sales of listed equities) as and when the holdings in the investee companies breaches threshold

of multiples of 5%. The asset managers are prohibited from acquiring shareholding of more than 35% in a listed investee company, unless they have obtained prior exemption from the TRP to exceed the limit. The requirements regarding the 5% multiple rule give rise to a reporting obligation by asset managers to the investee companies, which in turn should report to the TRP and JSE for purposes of making Stock Exchange News Service (SENS) announcement which is meant to inform the market about the shareholding by the asset manager in that investee company, for transparency. This requirement could be quiet onerous for large asset managers, such as the Public Investment Corporation SOC Limited (PIC) and Investec Asset Management (Pty) Ltd, which have huge AUM of R1.8 trillion and R1.3 trillion respectively, especially the PIC with JSE market capitalisation of about 13%.

3.5 The unintended consequences of regulation

The most obvious consequences of regulation is the cost of compliance, in so far as implementing measures required by regulation are concerned. Regulatory compliance siphons more and more revenue towards legal and audit fees (Davis 2004).

Klinz (2016: 3) points that the principle of proportionality has not been observed as envisaged, and especially tedious and overlapping reporting requirements to supervisors have become an immense operational burden on many industry participants. Moreover, many fund managers are concerned with what they believe is a one-size fits all approach to regulation (McCann 2015: 1). Klinz (2016: 3) agrees that the current trend towards regulating all financial services companies in the same way is questionable. One issue, in particular, that the asset management industry is constantly being faced with is that it is confused with the banking sector and not perceived for what it is: an agency business. As such, its business model is different from other financial services firms and its business proposition is to assist clients reach their investment objectives (Klinz 2016: 3)

The current regulatory boom is intended to "…significantly lessen opportunities for corporate mismanagement and instances of corporate collapse and thereby provide better protection for shareholders and other business stakeholders" (Durden and Pech 2006: 84-89). Whilst the intention and motivation behind increased regulation may be well founded, there is an emergence of evidence that regulation has some consequences that were not intended by governments. According to the World Bank (2004) heavier regulation is associated with more inefficiency, higher costs, and corruption. It also has the perverse of harming those it is intended to protect in that entrepreneurs are encouraged to operate in the informal economy (World Bank 2004). It also appears to result in sluggish decision-making on the part of executives and to changes in the composition of boards of directors.

Durden and Pech's (2006) findings concur with those of Davis (2004) who believes that increasing rules and codes have heightened expectations of directors and risk managers. These changes have created the danger that management may become lured into box ticking that tends to make business risk-averse. According to Davis (2004: 13) "Managing risk lies at the heart of corporate regulation, and of business itself. Business risk is a good and necessary thing. To avoid it is to guarantee that business will wither and die".

The Economic Intelligence Unit (2012: 23) argues that one of those unintended consequences may be that asset managers decide that it is no longer financially viable to use derivatives to hedge risk. "The underlying risk will clearly continue to exist, but will be borne by a group of people less equipped to manage it".

3.6 Conclusion

The regulations aim to ensure that benefits such as stability, consumer protection, efficiency and competition (Sprong 2000: 43) will provide a positive contribution to the economy and the consumers of financial services. In the debate regarding strict regulations versus lenient regulations, Rose & Hudgins (2010: 33) argue that lifting

financial regulations would subject financial services providers to greater risk and eventually result in more failures. Consumers have limited capacity to effectively monitor complex financial products, so prudent financial regulations are critical to maintaining the stability of the financial sector (Kima, Koob, & Park 2013: 662-672).

The enormous costs of the watershed events of 2007-2009 have forced governments to reconsider how they approach financial sector regulation. Most regulators, particularly in advanced economies, were taken by surprise by the events of 2007-2009 and were unable to anticipate the rise in systematic risk that culminated in the crisis. The South African financial sector did not experience the financial upheaval seen in advanced economies and, as a result, the economy is in a favourable situation to recover from the downturn and emerge stronger than ever before. The South African policy components that protected the country from financial and subsequent sovereign crisis include, amongst others, a sound framework for financial regulation and well –regulated institutions, and have ensured that potential risks were anticipated and appropriate action was taken to mitigate them. South African regulators have generally not taken a light-touch approach (National Treasury 2011: 23-30).

The worst of the 2008 financial crisis has passed, however the world economy continues to face many challenges. The long term impact of the regulatory reforms implemented in the aftermath of the 2008 financial crisis will be positive, because banks' cost of market debt is negatively influenced or reduced by higher capital and liquidity resources- which new regulations seek to improve (Galiay and Maurin 2015: 2). More regulatory reform is likely to increase economic growth by creating the necessary financial infrastructure for international investors to enter the market and push local players to invest more domestically (PWC 2015:19).

By moving from prosecution after the fact to ongoing examinations the financial system is likely to experience less destructive bubbles and crashes. Bubbles and crashes are indeed likely to continue, regardless of rules and regulations. However, a move from after-

crash prosecution to ongoing long-term examinations, with sensitivity to violations of the law that are likely to accompany bubbles, may minimize the devastating impact of crashes (Frankel 2009: 25). The public policy underlying the regulatory system is aimed at maintaining investors' trust. Many legal rules are based on this objective, imposing limitations and duties to enhance investors' reasonable belief in the truthfulness and reliability of the issuers and the intermediaries of the financial system. While regulators relax rules and adopt a "wait and see" policy during the rise of bubbles, they take steps to tighten regulation and impose new ones. They examine crashes with great care to determine why and how the "horse got out of the barn" (Frankel 2009: 14-15)

Notwithstanding that the regulatory universe affecting the asset management industry is onerous, which may limit entry into the industry, there is however evidence to suggest that the regulations are achieving the intended primary objectives of mitigating the risk of misappropriation of clients' investments (or protection of consumers) and corporate (or market) failure. It is further noted that regulation of asset managers, in turn stimulates economic growth and creates an enabling economic environment through sustainability and transparency of the business of asset managers. It can thus be concluded that, the regulation affecting the asset management industry is justified.

Chapter Four: The impact of regulation on the asset management industry: Interpretation of results

4.1 Introduction

This Chapter assesses the impact of regulation on investment management companies, based on the results of the survey conducted and the response received from representatives of the asset managers. It reflects on the costs and benefits of regulation of the asset management industry and whether the current applicable legislative universe is justified and beneficial, including whether it is achieving the intended objectives. It looks at the efficient and effective strategies that may be adopted by asset management companies, for purposes of ensuring compliance with regulations.

The ethical clearance to conduct the survey based on the designed questionnaire was granted by the UNISA Research Ethics Review Committee. The purpose of the study was clearly explained to the participants. The consent to partake was received from the participants and they were explicitly advised that participation in the study is voluntary and they can withdraw at any time. It was stated that all participants will remain anonymous throughout the research, and once the questionnaire has been completed, all data will remain confidential. Once all questionnaire were collected and analysis conducted, the results of the study were presented as a whole or in aggregate form to ensure anonymity and written up as a scholarly paper. The participants were further advised to request a copy of the research should they wish to have it.

An electronic questionnaire was compiled after studying the literature and theories on regulation of asset management companies. The questionnaire was distributed to a sample of participants from a list of FAIS Category II Financial Services Providers (FSPs), registered with the Financial Services Board (FSB), as at 31 July 2014**.** The participants were randomly selected from a population (list) of six hundred and fifty (650) Category II

FSPs. The questionnaire was completed by either the Compliance Officer or Key Individual (or Portfolio Manager) from the selected entities. A high level cost-benefit analysis (CBA) of the regulations was conducted, with a view to assess the impact of these compliance requirements. The CBA looked at the advantages and disadvantages of such regulations, as per observations by the respondents.

The data analysis was done by capturing all the responses on a Microsoft Excel spreadsheet and converting it into statistical data. The Statistical Package for Social Sciences (SPSS) was used to compute the summary tables of the descriptive statistics in relation to the mean, median and standard deviation. Due to the nature of each different question, the statistical outcomes were interpreted individually per question. It should, however, be noted that the final sample remained the same and biographical profiles are analysed in the beginning of this Chapter. The rest of the analysis is also presented hereunder. The presentation of the results differs from question to question, depending on suitability. The data analysis was done by capturing all the responses on a MS Excel spreadsheet and converting it into statistical data. The data collected is analysed by using, amongst others, bar charts, pie charts and tables. This would be followed by descriptive interpretation and outline of the results in detail.

The following minimum criteria was used to draw a population of asset managers to participate in the survey:

- The asset manager should be a legal entity (i.e. private company);
- The asset manager should have at least one or more compliance officer(s);
- The asset manager should have at least one key individual and one or more representative(s);
- The asset manager should have asset under management (AUM) of at least R1million;
- The asset manager should have full discretion to make investment decisions on behalf of the clients;

- The asset manager should have authorization to invest in two or more asset classes; and
- For asset managers using the same external or outsourced compliance practice to perform compliance function, select not more than two such asset managers.

Thus, although there are a total of 650 Category II FSPs that registered with the FSB, the number of entities that fit into the profile of the population required were about 210. A survey questionnaire was designed and sent to a randomly selected sample of 90 respondents for completion. However, the feedback was received from 50 respondents, which is considered reasonable to make informed conclusions. The lack of response from other selected participants could be attributable to a number of reasons, such as the lack of interest to participate or the perceived level of sensitivity of some of the questions, which might have required prior approval from Management of the entities, before the respondents could disclose the information.

The responses received reflect a diverse sample, which is representative of the population targeted. The diverse nature of the sample is evidenced by a collective of the following distinctive factors:

- The relative balance of respondents, in terms of gender (64% male and 36% female) as well as position held in the asset manager (58% compliance officers and 42% portfolio managers);
- The number of years of experience of respondents in the asset management industry, with for example the majority (58%) having more than 10 years, 30% between 6 and 10 years, and only 8% between 3 and 5 years;
- The variety in the value of assets under management, ranging from R1million to over R1trillion;
- The number of years the asset manager was in operation, with majority (68%) been existing for more than 10 years; 14% between 6 and 10 years, 16% between 3 and 5 years, and lastly only 2% for less than 3 years; and

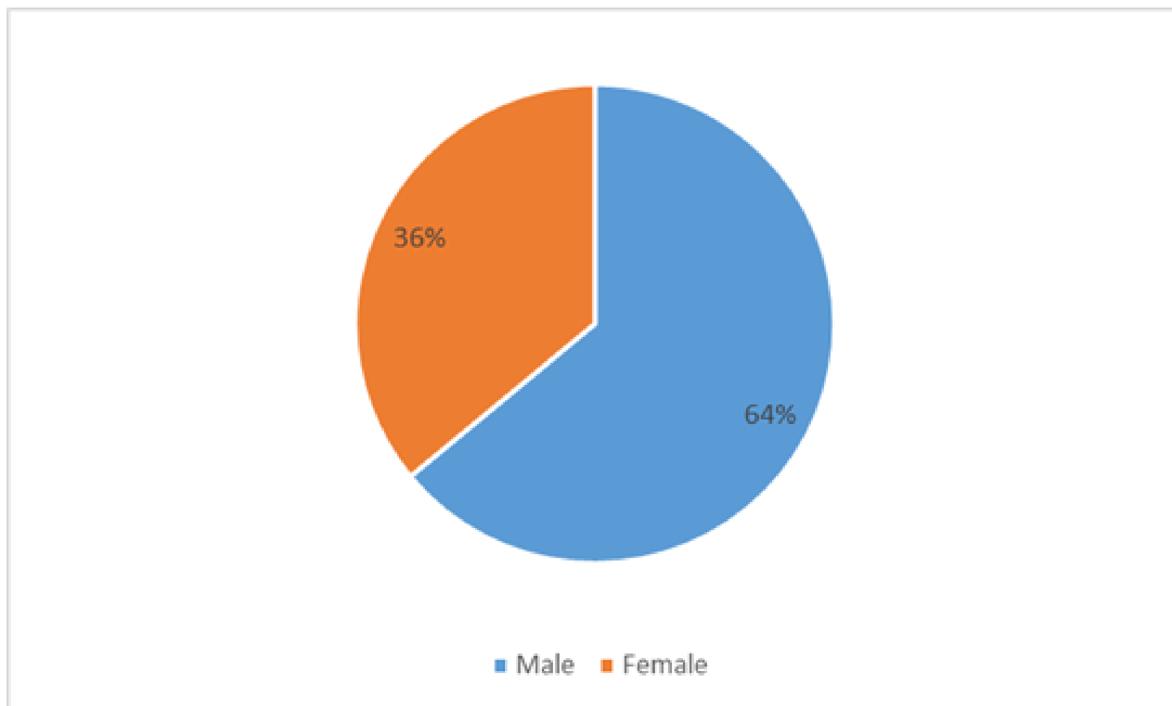
- The balance in terms of investments in different geographic markets, for portfolio diversification purposes.

Moreover, in terms of the FAIS Act, all FSPs, including asset managers, are required to appoint at least one key individual. Not all FSPs (asset managers) are required to appoint a compliance officer. Only FSPs that have at least one key individual and representative(s) are required to appoint a compliance officer. Furthermore, the same key individual may be appointed as compliance officer, provided they meet all the fit and proper requirements for both portfolios.

4.2 Profile of Respondents

The total sample is fifty (50) respondents, made up of compliance officers and portfolio managers (key individuals), from asset management companies.

Figure 8 - Gender of respondents



The results reflect that 64% of the respondents are male while 36% are female. The gender profile of respondents also provides us with significant findings. The fact that closer to two thirds of the respondents are male could reflect on the fact that males are historically dominant as employees in most specialized sectors. However, the number of female employees is also significant, showing a clear trend of an increase in the female entering the asset management industry. This view is supported by the survey conducted by BEE.conomics (2015: 41- 50), which found that while the number of males declined, the number of women entering the asset management industry grew with the main beneficiaries being African women. The number of female employees in the asset management industry has steadily increased from 2010 (93) to 2014 (125) and 2015 (151). Comparatively, male employees increased from 2010 (123) to 2014 (196) and 2015 (186) (BEE.comonics 2015: 41-50).

Figure 9 - Portfolio of respondents

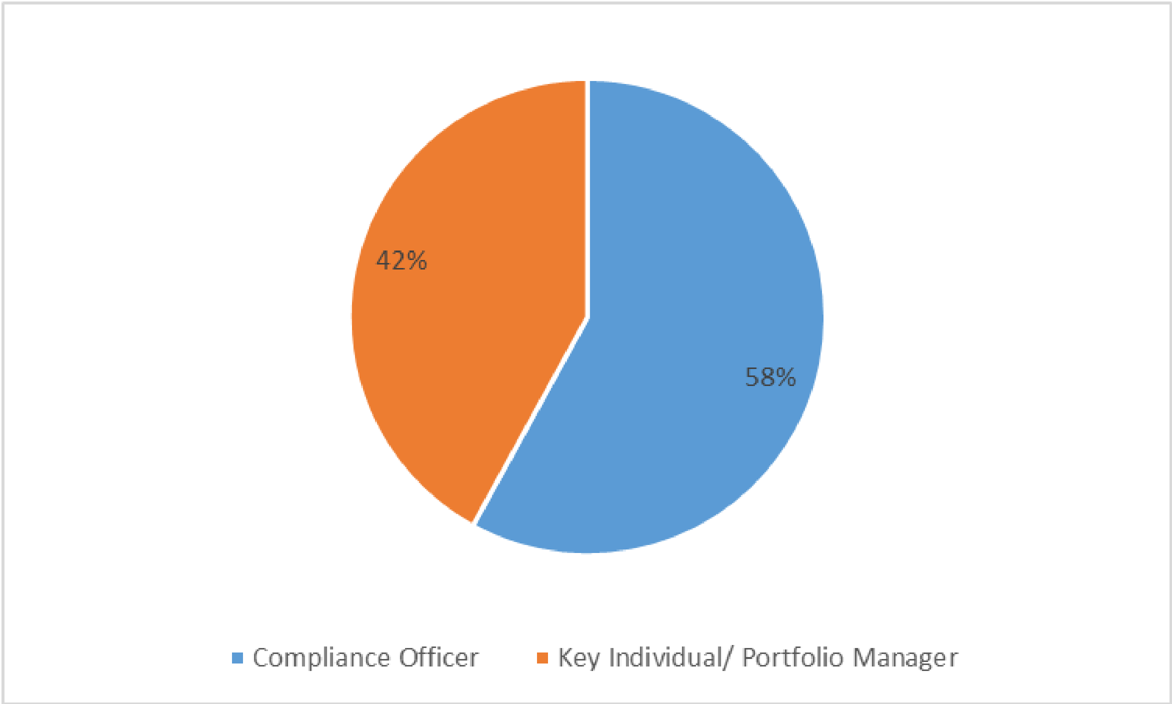
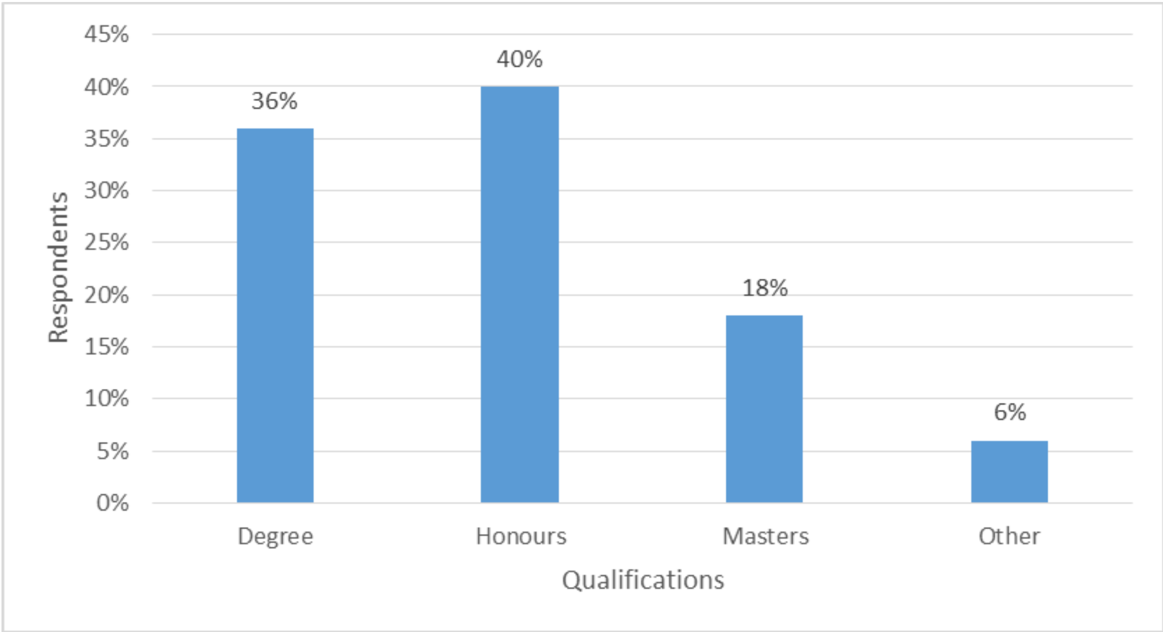


Figure 9 illustrates the split in terms of the portfolio of the respondents within the asset management companies, with compliance officer respondents being significantly higher

than portfolio managers (key individuals). The results indicate that of the 50 respondents, 58% are compliance officers and 42% are portfolio managers. This split suggests that both the compliance officers and portfolio managers are relatively fairly represented and the representation is reasonable enough to ensure balanced and inclusive views regarding impact of regulation on asset managers. Thus, the compliance officers are predominantly at the forefront of providing compliance guidance to business and are responsible for providing compliance assurance to the Management, Board and Regulators. It is anticipated that their slightly higher representation in the sample will most likely strengthen the validity and reliability of the outcomes of the survey.

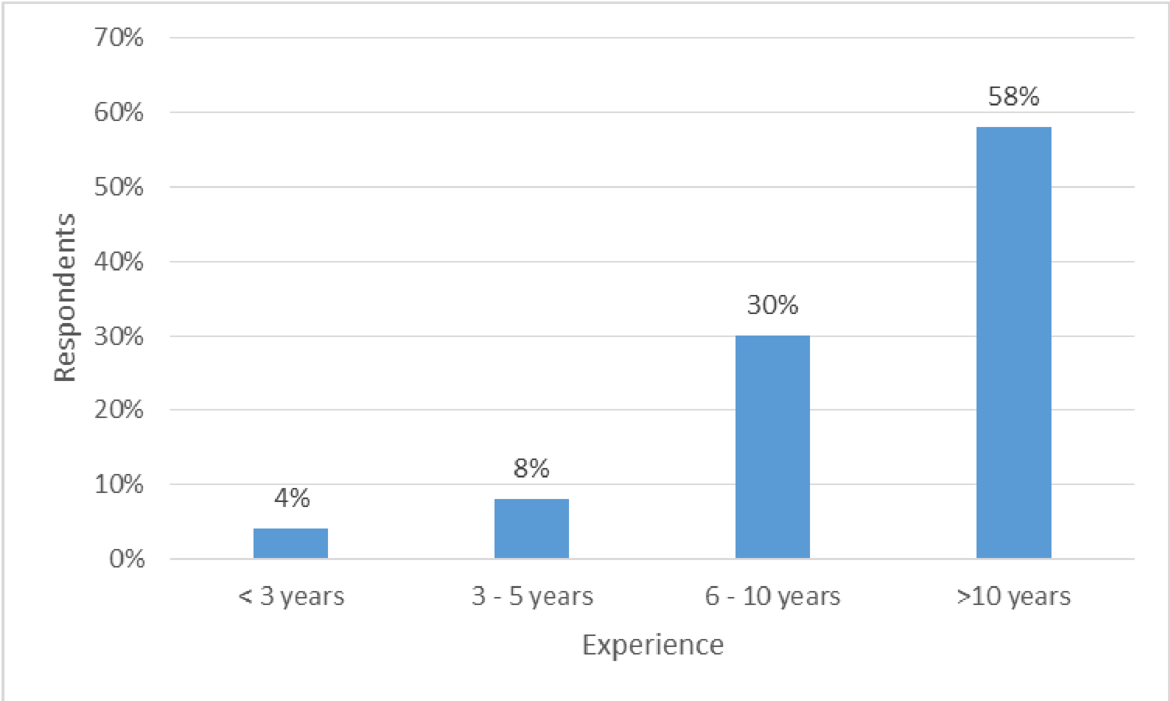
Figure 10 - Qualifications of respondents



The FAIS fit and proper requirements in respect of qualifications and experience for both compliance officers and portfolio managers (key individuals) in asset management companies are predominantly minimum three (3) years' experience and a commercial or legal degree with appropriate subjects, respectively. These requirements are reflected in the results of the survey, where 18% respondents have Masters Degrees, 40% have Honours degree, 36% have Degrees and the remaining 6% under Other represent CA

(SA) and/ or Charted Financial Analyst (CFA) qualifications. The results are depicted in figure 10 above.

Figure 11 - Experience of respondents



The results indicate that 58% of the respondents have more than 10 years of experience in the asset management industry, 30% have between 6 and 10 years of experience, 8% have between 3 and 5 years of experience and lastly only 4% have less than 3 years of experience. The FAIS fit and proper requirements provides that of the 3 years minimum experience required, at least 1 year must have been obtained in the asset management industry and the other 2 years in the financial services industry in general. This should explain why 4% of the respondents have less than 3 years of experience in the asset management industry.

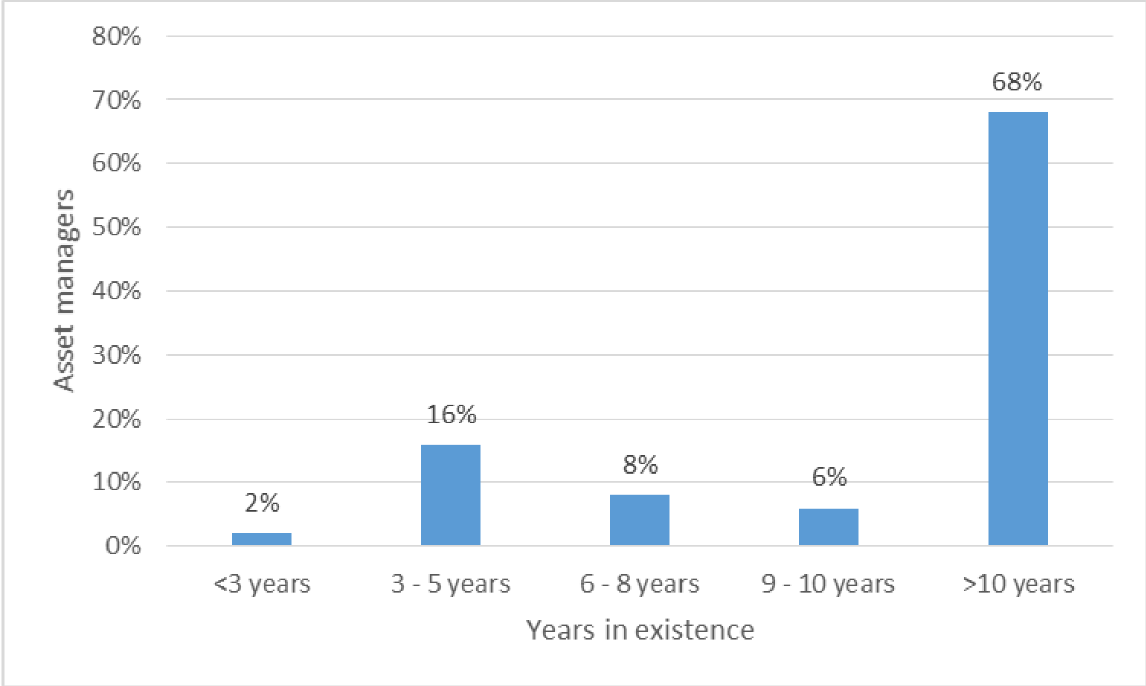
The respondents were further asked how many years have they been with their current employer. Most (48%) respondents indicated that they were with their current employer

for 2 to 5 years, 32% more than 8 years, 12% said less than 2 years and only 8% said between 6 to 8 years. The results could reflect the extent of the scarcity of skilled and experienced portfolio managers and compliance officers in the asset management industry, as it is a specialised industry. This is probably reflected in the apparent movement of the personnel, because although the majority (58%) of the respondents have more than 10 years' experience in the industry, most have also spent a shorter period with their current employers.

4.3 Profile of Asset Management Companies

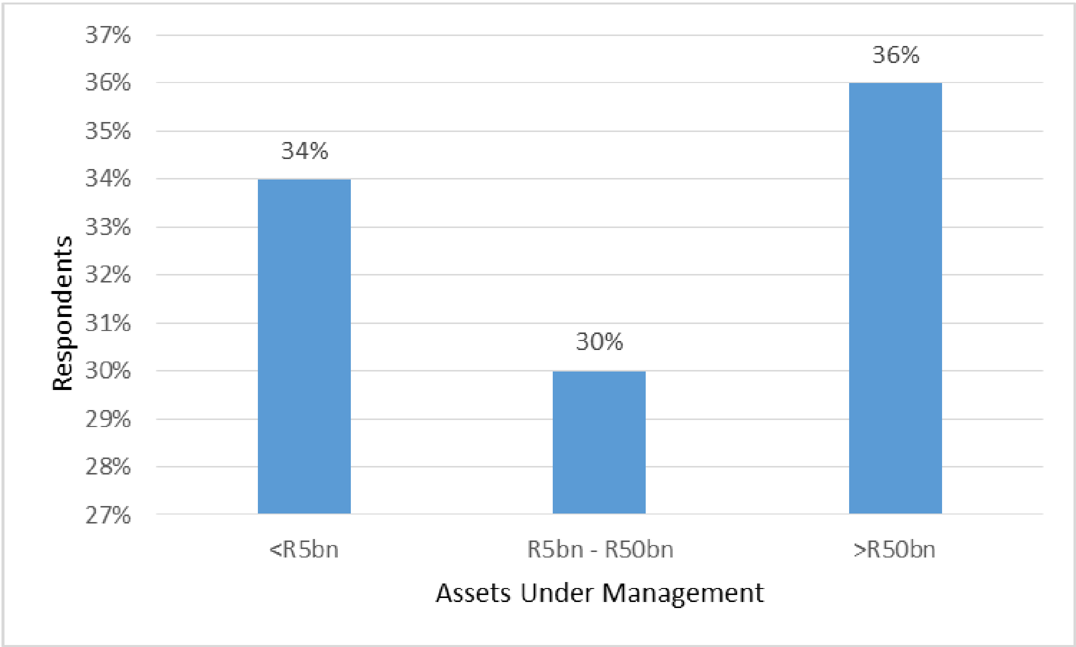
The section below looks at the profile of the asset management companies that participated in the survey, including the duration that the entities were in existence, the value of assets under management and the geographic markets where the entities invest the funds.

Figure 12 - Asset Managers' number of years in operation



The respondents were asked how long the companies that they currently work for have been operational. The results show that 68% of the asset management companies have been operational for more than 10 years, 14% for between 6 and 10 years, 16% for between 3 and 5 years, and lastly only 2% of the companies have been existing for less than 3 years. The results suggest that in light of the strides made regarding the transformation drive in the asset management industry and growth in consumer demand for securities and instruments products, there are more asset managers taking advantage of the opportunities.

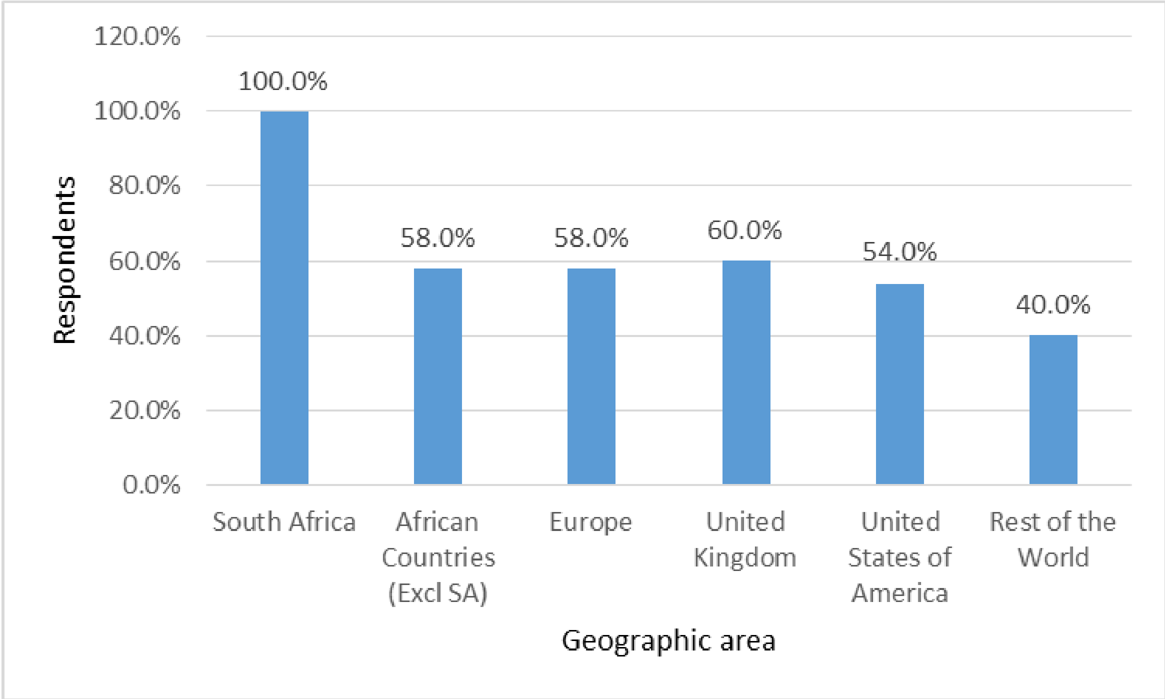
Figure 13 - AUM of the asset management companies



The results show that 34% of the asset management companies have assets under management (AUM) of less than R5 billion. The outcomes further indicate that 30% of the asset managers have AUM of between R5 billion and R50 billion and the remaining 36% have AUM of above R50 billion. It should further be noted that of the 18 companies with AUM of more than R50 billion, 2 of them have significant AUM of between R500 billion

and R1trillion, while the other 5 have AUM of more than R1 trillion. There is further a correlation between the number of years in operation by the asset manager and the value of AUM. It appears that the longer the number of years in existence by the asset manager, the greater the AUM.

Figure 14 - Jurisdiction where the asset management companies invest



The respondents were asked in what geographic markets do the assets management companies invest. Of the 50 respondents, 100% indicated that they invest in the South African markets in securities such as equities, money markets and bonds, while only 27% do not invest in any other markets other than in South Africa. The results also indicate that 58% invest in other African Markets (excluding South Africa) and Europe, 60% in the United Kingdom (UK), 54% in the United States of America (USA) and 40% said they invest in the Rest of the World. The results suggest that most asset management companies invest in multiple of jurisdictions for purposes of, amongst others, portfolio

diversification, which is what the client investment mandate will stipulate, in line with the FAIS Act requirements.

4.4 Analysis of Responses Received

The results presented hereunder seeks to, amongst others, provide clarity to the research questions raised in Chapter 1, based on the outcomes of the survey conducted.

Figure 15 - Asset Managers working relationship with Regulators

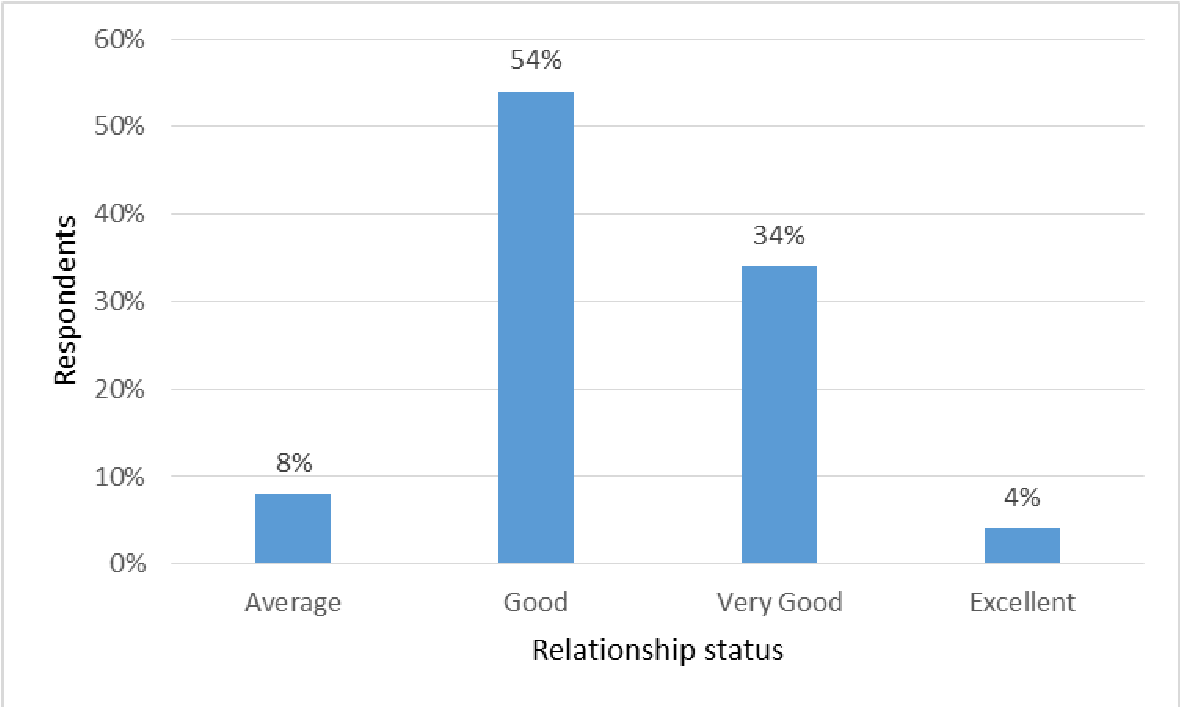


Figure 15 indicates that 54% responded that they rated the working relationship with the Regulators as good, 34% as very good, 4% as excellent and only 8% said average. This means that 82% of the respondents are happy with the assistance or guidance received from the Regulators, which is a positive outcome from the regulator perspective.

Figure 16 - Number of on-site reviews from FSB and/ or FIC in past 5 years

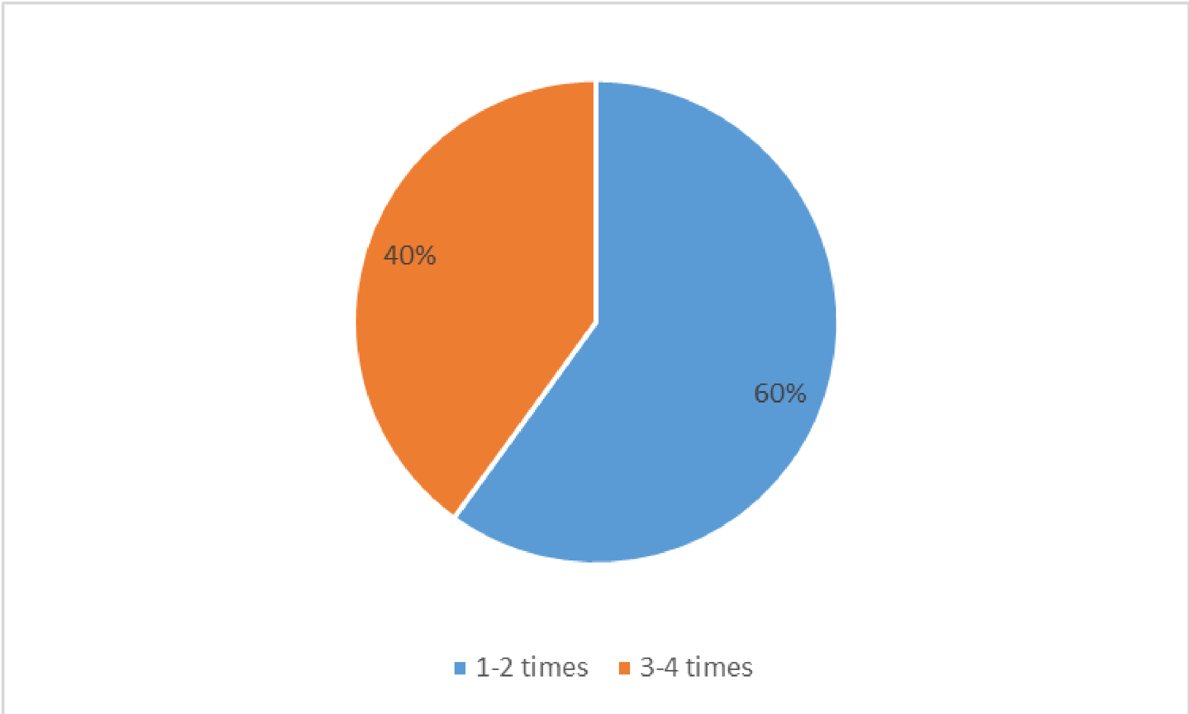
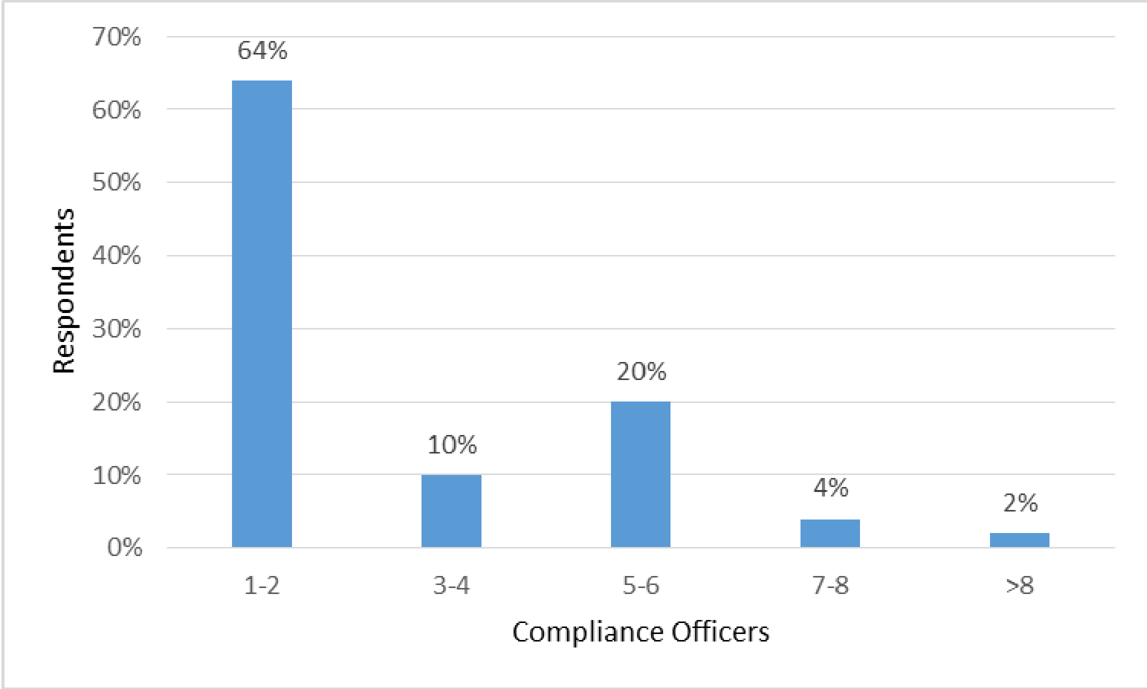


Figure 16 reflects that 60% of the respondents indicated that the asset management company had 1 or 2 on-site reviews from the Regulators, while 40% had 3 or 4 on-site reviews, in the past 5 years. It would appear that the greater the company in terms of the AUM, the more the on-site reviews by the Regulators. Thus, the Regulator would ordinarily channel more of its resources in terms of compliance monitoring towards entities where, in the event of corporate failure the impact would be catastrophic for most consumers, the company and the economy in general. This approach is reflected in the Risk Based Supervision methodology adopted by most Regulators, particularly the FSB and FIC.

Figure 17 - Number of compliance officers that perform compliance functions



The majority (64%) of the asset managers have up to 2 compliance officers that perform compliance functions. The respondents also indicated that 10% and 20% of the asset managers have between 3-4 and 5-6 compliance officers, respectively. Lastly, 4% of the respondents said they have between 7-8 compliance officers, while only 2% said they have more than 8 compliance officers. On the other hand, the majority (74%) of the respondents confirmed that their asset managers were adequately staffed to effectively and efficiently perform compliance functions. The remaining 22% and 4% indicated "No" and "Maybe" respectively, to the question of whether they are well capacitated.

Overall, the results present a worrying picture about the lower number of compliance officers (at most 2) in most companies (64%), dedicated towards compliance monitoring and guiding the business in complying with regulatory requirements. Thus, it would

appear that the asset managers are largely complying with the bear minimum requirements in terms of section 17 of the FAIS Act, which provides that at least one compliance officer be appointed, in order to monitor compliance and provide compliance assurance to Management, Board of Directors and the Regulator. The FAIS Act further requires that all personnel that are responsible for compliance monitoring of the business/ investment activities, obtain approval from the Regulator.

The lower number of compliance officers could be attributable to a number of reasons, such as placing reliance on other compliance personnel that are not registered with the FSB, which may not be reflected in the official number of compliance officers provided by the respondents. This may be compliance personnel that provide support on compliance administrative functions, which does not require approval from the Regulator. However, there could potentially be other compliance personnel that conduct compliance monitoring on financial services/ investment activities under the supervision of approved compliance officers, which amounts to breach of the FAIS Act if such compliance personnel are not registered with the Regulator to render compliance services under supervision.

Figure 18 - Strategies adopted to thrive in current regulatory environment

This question was formulated to address one of the key objectives of the study and that is to investigate the strategies adopted by asset managers in order to thrive in the current regulatory environment or to effectively and efficiently comply with regulations. Almost all the asset managers adopted multiple strategies in order to ensure continuous compliance with the regulatory requirements. This is reflected in the respondents' feedback where there are similar strategies pursued that cut across most of the asset managers.

The employment of experienced compliance officers (40%), having regulator meetings and close working relationship with Regulators, including affiliation with industry professional bodies (34%) and outsourcing of compliance function to external experts to maintain independence and objectivity (32%), came as the top 3 strategies adopted by most asset managers to manage compliance risk. The relatively decent number of respondents indicated that their asset managers have adopted strategies ranging from risk based approach compliance methodology (28%), providing regular training and workshop to employees (20%) and integration and incorporation of regulatory requirements into business processes and procedures (20%).

The diverse nature of the strategies adopted by various asset managers could be attributable to a number of factors such as the size of the company, the size of AUM, the capacity of the compliance function/ department, the nature of the clients and the type of investment products offered.

Table 9 - The reasons for establishment of compliance function by asset managers

Rationale/ Reasons	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	Mean	Median	Standard Deviation
The appreciation of compliance by the Board and/ or Senior Management	76%	14%	4%	2%	4%	1.44	1.00	.0972
Severe regulatory penalties that may be imposed for failure to comply	40%	40%	12%	2%	6%	1.94	2.00	1.077
Mitigation of reputational risk	68%	30%	0%	0%	2%	1.38	1.00	.697
The value added by regulatory compliance towards the business activities	20%	64%	8%	4%	4%	2.08	2.00	.900
Understanding of the benefits of compliance	40%	50%	4%	4%	2%	1.78	2.00	.864
Understanding of the costs of non-compliance	70%	22%	6%	0%	2%	1.42	1.00	.785
Contribution of regulations towards making the financial system secure	42%	42%	12%	0%	2%	1.80	2.00	.881

Serve to maintain a good relationship with the Regulators	34%	46%	14%	4%	2%	1.94	2.00	.913

To simplify the discussion of the outcome, the “strongly agree” and “agree” statements options are combined and compared against the combination of “disagree” and “strongly disagree” statements. The respondents strongly attributed the establishment of the compliance function within their asset managers to the appreciation of compliance by the Board and/ or Senior Management (76%), mitigation of reputational risk (68%) and understanding of the costs of non-compliance (70%), as reflected by the median of 1. The second closest reasons for establishment of compliance function were attributable to severe regulatory penalties that may be imposed for failure to comply (40%), the value added by regulatory compliance towards the business activities (32%), understanding of the benefits of compliance (50%), contribution of regulations towards making the financial system secure (21%) and lastly that it serves to maintain a good relationship with the Regulators (46%), as reflected by the median of 2.

The fact that the overall response reflects a median of less than or equal to 2 means that only few respondents (less than 4%) disagreed that the establishment of compliance function was a result of the above mentioned reasons. The standard deviation represents the number used to tell how measurements for a group are spread out from the average (mean) or expected value. The low standard deviations (all but one) means that most of the numbers are very close to the average (mean), while the higher standard deviation (i.e. 1.077) indicate that the numbers are spread out over a wider range of values, as reflected in table 9 above. The higher standard deviation for the question relating to severe regulatory penalties that may be imposed for failure to comply as part of the reasons for the establishment of the compliance function, could reflect the variance in the interpretation of this question by the respondents.

Figure 19 - Legislation where most time is spent

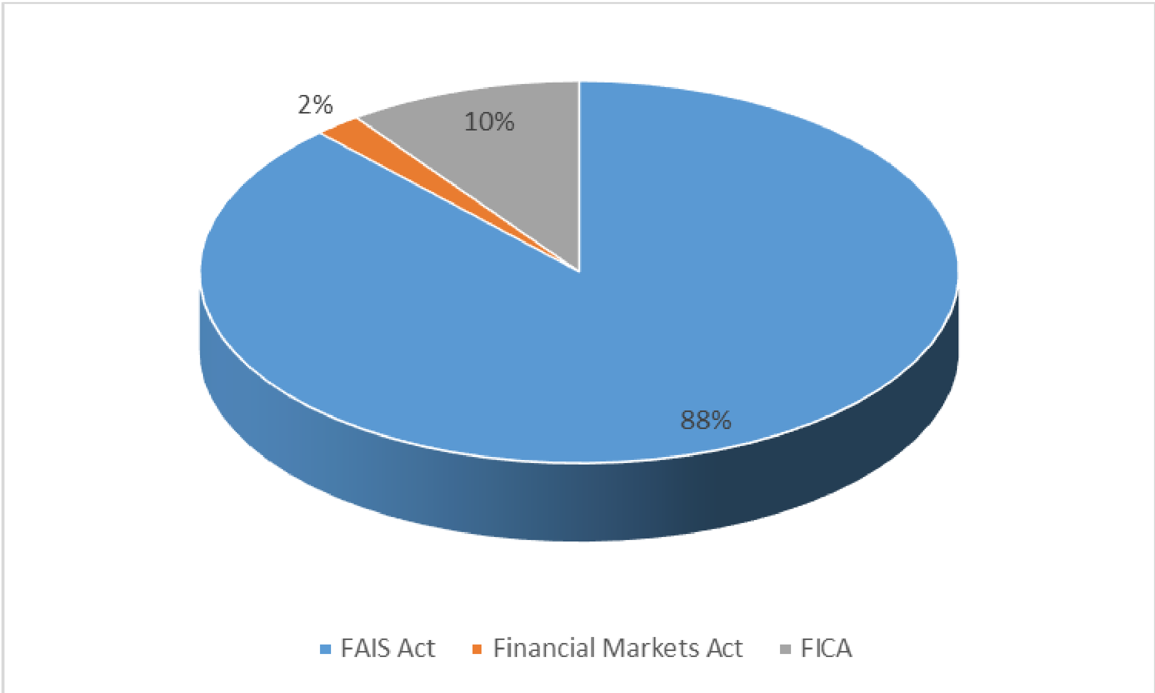
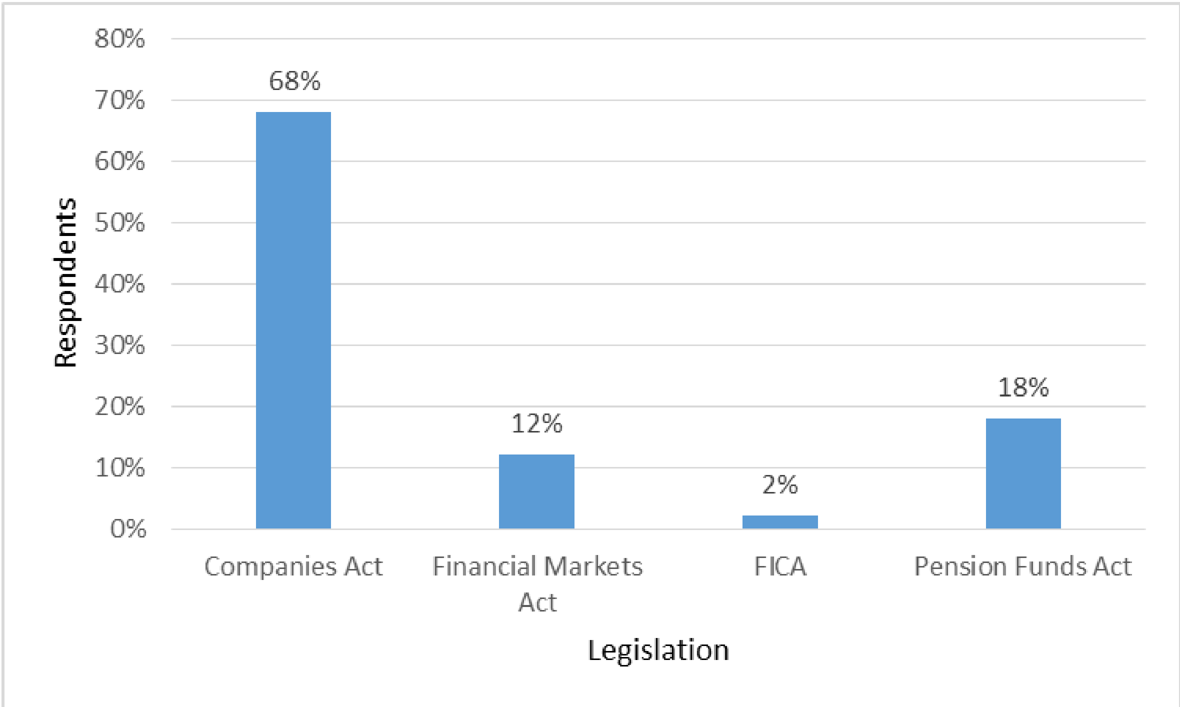


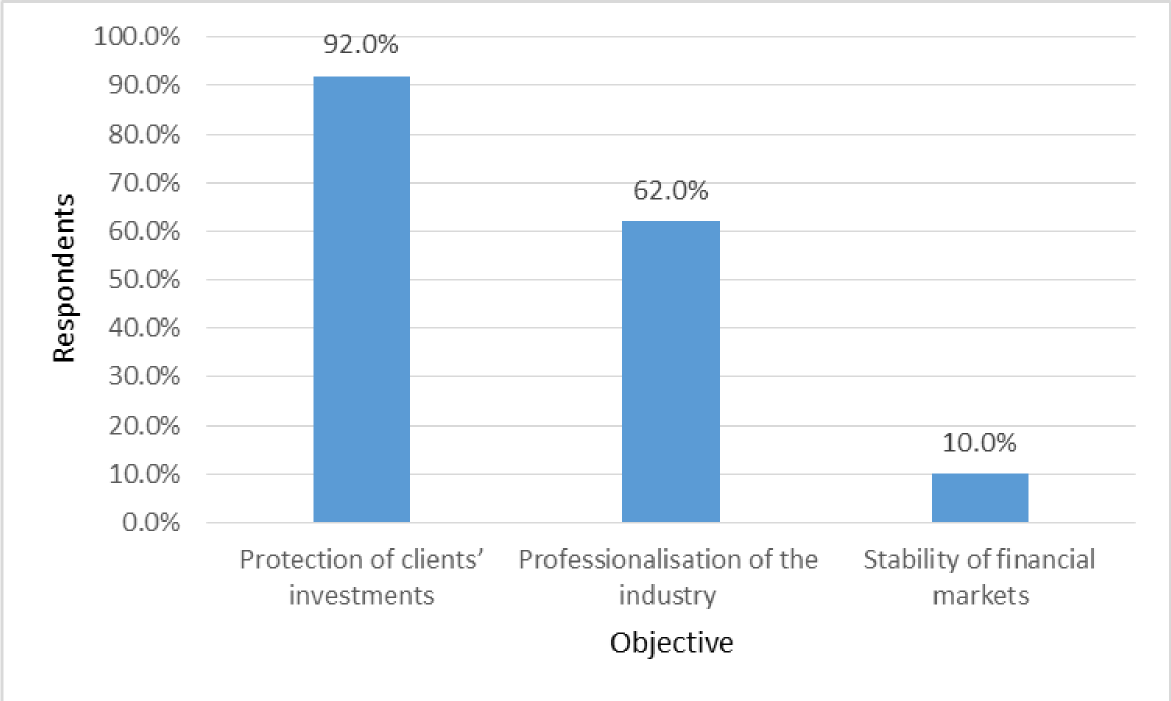
Figure 20 - Legislation where the least time is spent



The feedback from the respondents shows that almost all the respondents indicated that the FAIS Act, Financial Markets Act, Companies Act and FICA, were applicable to their Asset Manager. The majority (88%) of the respondents said that their asset manager spent most of the time on the FAIS Act, in terms of compliance monitoring/ activities, while only 10% said they spent most of the time monitoring compliance with FICA. On the other hand, 68% of the respondents said they spent the least time on compliance monitoring or activities regarding the Companies Act, 18% on the Pension Funds Act, 12% on the Financial Markets Act and only 2% on the FAIS Act. Thus it can be concluded that most asset managers dedicate most of the time and resources towards monitoring compliance with the FAIS Act, while only a bit of considerable amount of time is directed towards the Companies Act.

The severe nature of consequences for failure to comply with the FAIS Act dictate that more resources and time be channeled towards monitoring compliance with this legislation. The FAIS Act provides that the Regulator (FSB) may take regulatory action (e.g. suspend/ withdraw the FAIS license, issue monetary penalties, imprisonment) in the event that the FSP or its investment professionals fails to comply with the provisions therein. The impact of such regulatory action would have an impact on the reputation of the organization and the company will in all likelihood experience loss of clients and income. Thus the consequences of non-compliance could be very expensive, compared to the costs of compliance.

Figure 21 - Objectives of regulation of asset managers



The respondents were asked what they believed was the purpose or objective of regulation of asset managers. The majority (92%) of the respondents indicated that the main objective of regulation of asset managers is the protection of clients' investments, followed by professionalization of the industry through introduction of the fit and proper requirements (62%) and the stability of financial markets (10%). This outcome of the survey supports the finding of the literature review in prior chapters, where protection of consumers and professionalization of the financial services industry are regarded as the main objectives for regulation of asset managers (Van Zyl, Botha & Skerritt 2003: 121).

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Figure 22 - Benefits of regulation of the asset management industry

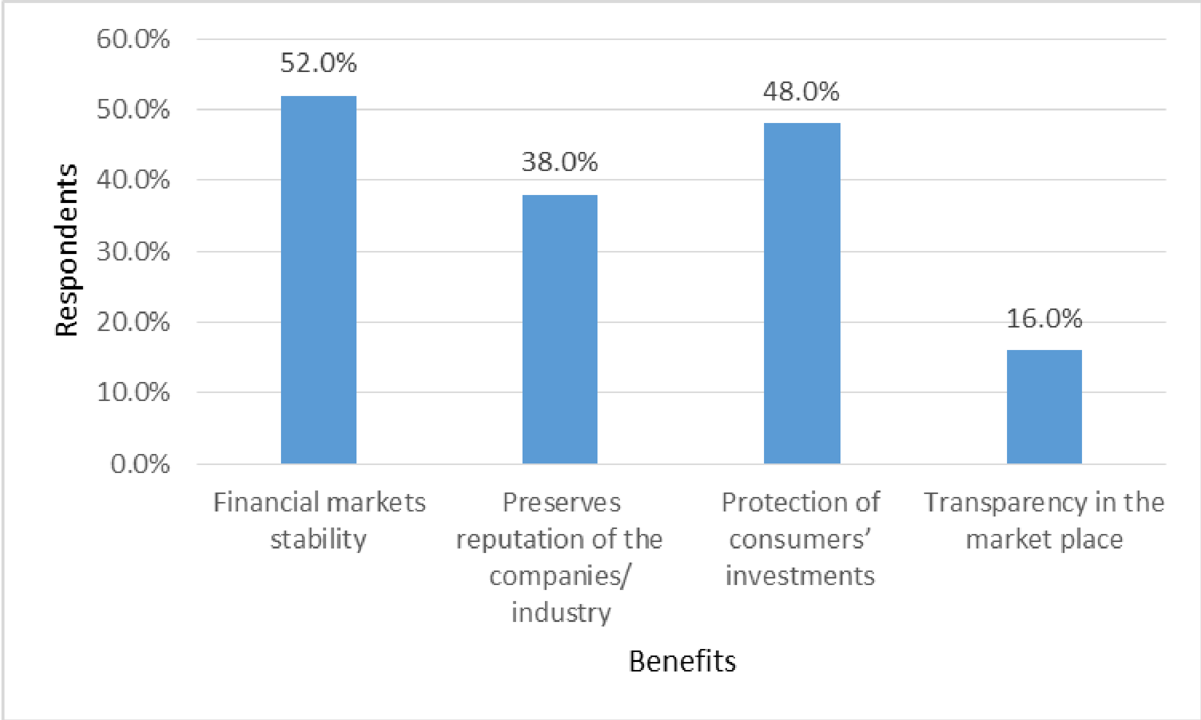
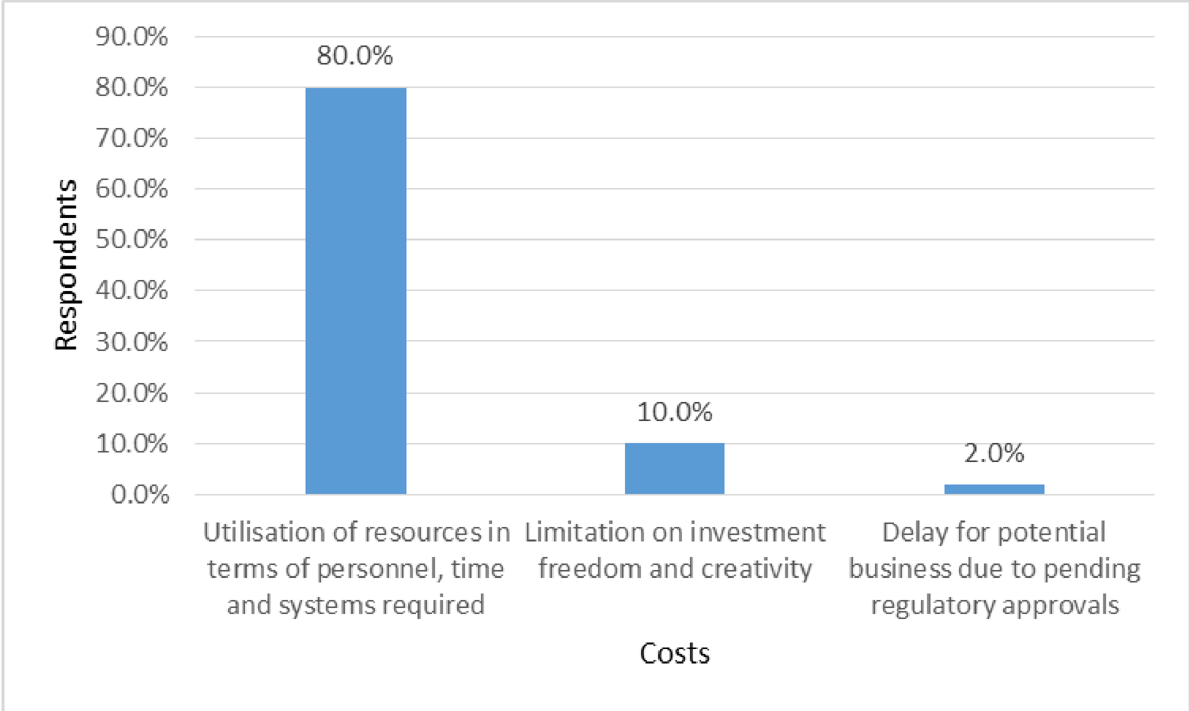


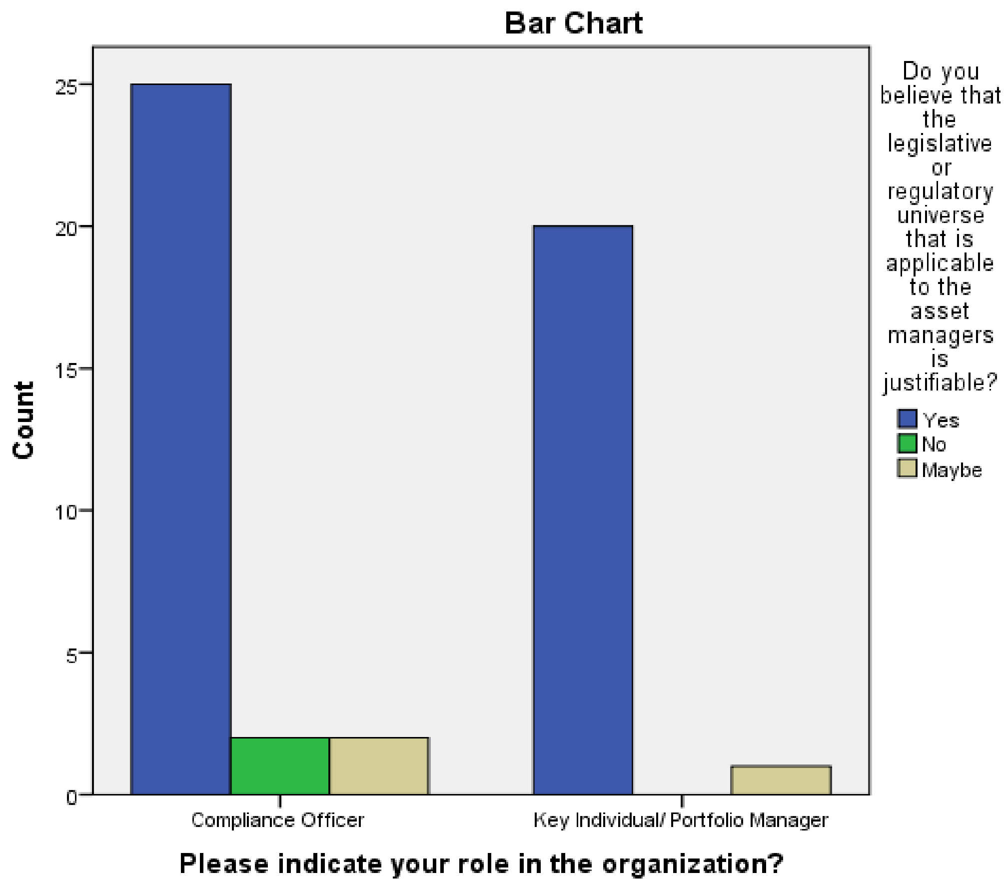
Figure 23 - Costs of regulation of the asset management industry



This question of costs and benefits of regulation, as reflected in figure 22 and figure 23, was posed to the respondents with a view to address one of the objectives of the study and that is to determine the costs and benefits of regulation of asset managers. The respondents cited the main benefits of regulation of the asset management industry to be financial markets stability (52%), followed by protection of consumers' investments (48%), preservation of the reputation and integrity of the companies/ industry (38%) and transparency in the market place (16%).

On the other hand, the costs of regulation of the asset management industry were identified as mainly acquisition or utilisation of resources such as compliance personnel, time and systems required (80%), followed by limitation on investment freedom and creativity (10%) and lastly delay for potential business due to pending regulatory approvals (2%). These outcomes of the survey support the finding of the literature review in prior chapters, since consumer protection and stability of financial markets were identified as the main benefits of regulation of the asset management industry (Sprong 2000: 43) and (Van Zyl *et al* 2003: 121), while employing compliance officers, deploying systems and time spent on regulatory compliance matters were cited as the main costs of regulation (Davis 2004).

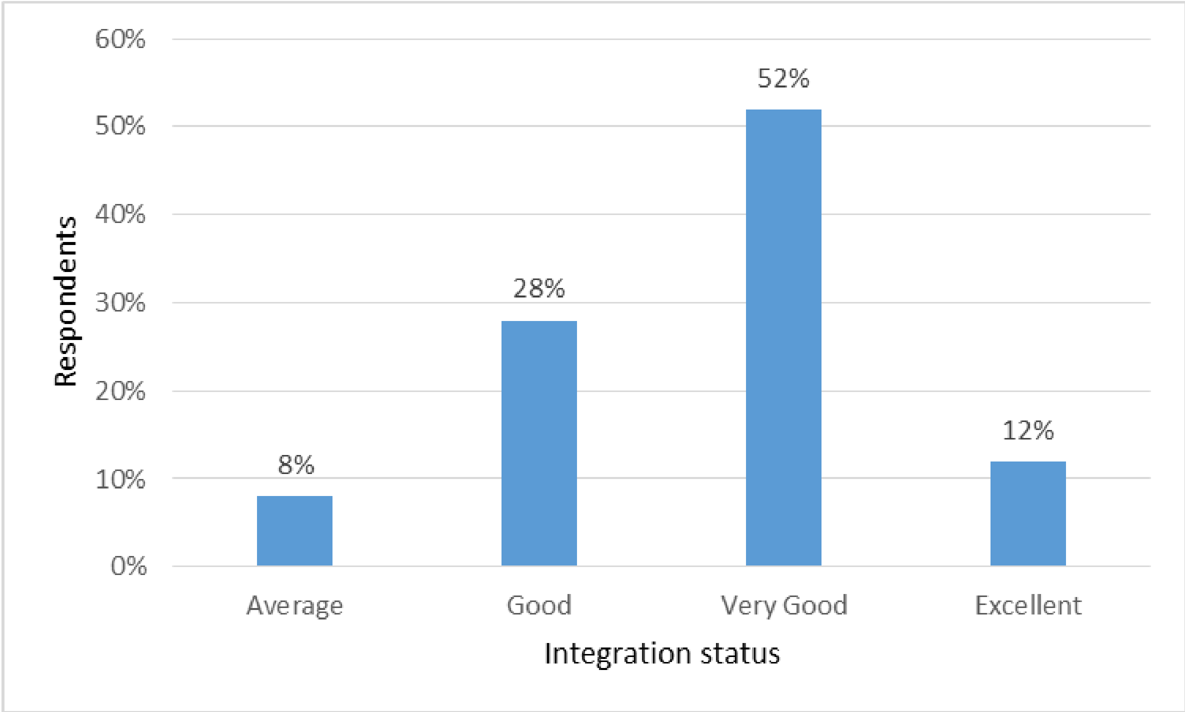
Figure 24 - Justification of regulatory universe applicable to asset managers



The respondents were asked whether they believe that the regulatory universe that is applicable to the asset management industry is justifiable. The overwhelming majority (90%) of respondents indicated that the regulatory universe was justifiable, while only 4% said it was unfair and 6% said they were not sure whether it is justifiable or not.

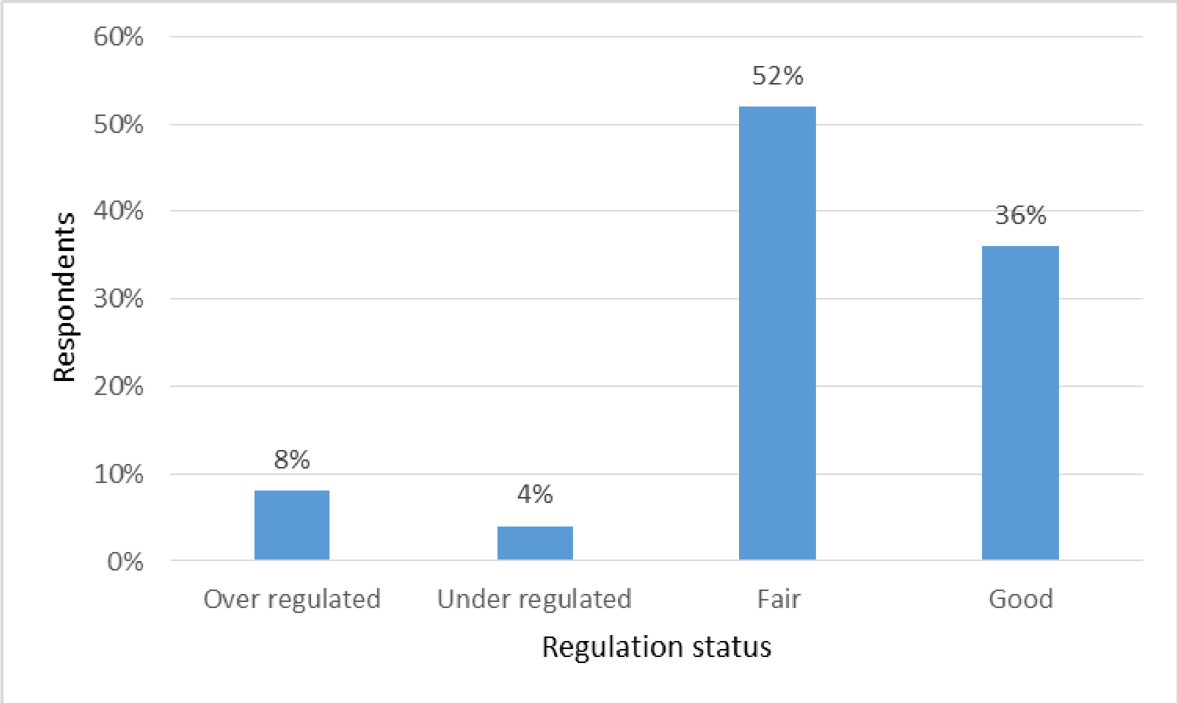
It is also interesting to note that of the 29 compliance officers and 21 portfolio managers, 86.2% and 95.2% respectively, agreed that the regulatory universe applicable to the asset management industry was justifiable. This is a reflection of the significance of how both these important stakeholders (portfolio managers and compliance officers) view the positive role of regulation in the asset management industry.

Figure 25 - Extent of integration of regulatory compliance into business processes



According to most (52%) respondents, the integration of regulatory compliance into the business processes within the asset managers was rated as very good. The other respondents rated the extent of integration as good (28%), 12% as excellent and only 8% as average. This demonstrates the maturity of controls put in place to mitigate the risk of non-compliance within the asset managers. It is further an indication of how the business and management appreciate the importance of regulatory compliance. It further points to the realization that compliance with regulatory requirements should not be treated as a separate exercise from the day to day business activities, if a culture of compliance is to be entrenched and embraced.

Figure 26 - Extent of regulation of asset managers



The respondents were asked about their view on the extent of regulation of the asset management industry. The outcome shows that the majority of the respondents believe that the regulations are fair (52%), followed by 36% (good), while only 4% and 8% of the respondents felt that the asset managers were under regulated and over regulated, respectively. This can be interpreted as a vote of confidence towards the regulation of the asset management industry by some of the key stakeholders (i.e. portfolio managers and compliance officers).

Table 10 - The advantages and disadvantages of regulation of asset managers

Advantage/ Disadvantage	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	Mean	Median	Standard Deviation
The benefits of regulation of asset managers exceeds the costs	58%	26%	10%	6%	0%	1.64	1.00	.898
The regulation of asset managers is achieving the intended objectives	4%	80%	10%	4%	2%	2.20	2.00	.670
Regulation of asset managers have negative impact towards economic growth and development of the asset management industry	2%	2%	6%	52%	38%	4.22	4.00	.815
Regulation of asset managers have positive impact towards economic growth and development of the asset management industry	10%	78%	10%	2%	0%	2.04	2.00	.533
The asset management	2%	44%	38%	16%	0%)	2.68	3.00	.768

industry is inclined to grow as a result of regulation								
Regulation of asset managers is contributing to the enabling economic environment	8%	62%	16%	2%	2%	2.28	2.00	.730
The compliance function or department is viewed as a business enabler within the asset manager	10%	66%	14%	8%	2%	2.26	2.00	.828
The compliance officers of the asset managers are generally sufficiently knowledgeable and experienced regarding regulations affecting the business.	20%	70%	6%	4%	0%	1.94	2.00	.652

This question was formulated to get directly to the core of the problem statement and that is to investigate the cost and benefits of regulation of asset managers, in relation to economic growth and development. To simplify the analysis of the results, “strongly agree” and “agree” options/ responses are interpreted as benefits or advantages, while the “strongly disagree” and “disagree” options will be interpreted as costs or

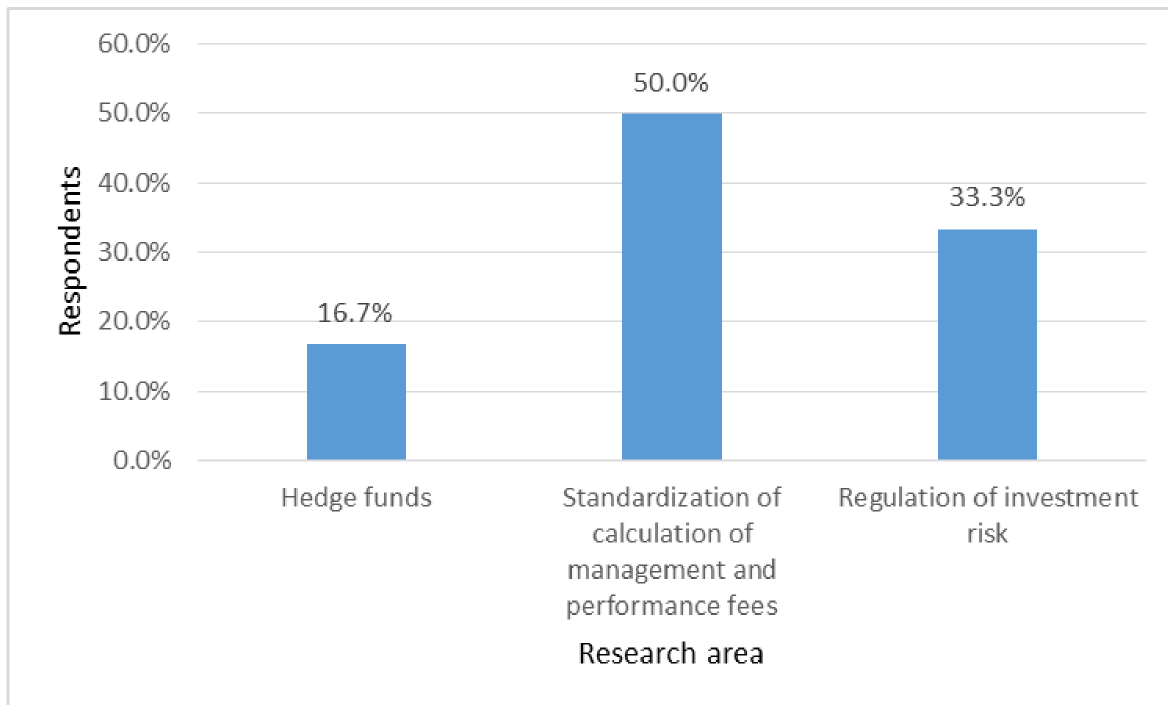
disadvantages. Finally, “neutral” responses will be interpreted to mean not sure whether benefits or costs of regulation of asset managers.

Table 10 reflects that the majority of the respondents thought that the compliance officers of the asset managers are generally sufficiently knowledgeable and experienced regarding regulations affecting the business (90%), regulation of asset managers has a positive impact towards economic growth and development of the asset management industry (88%), regulation of asset managers is contributing to the enabling economic environment (80%), the benefits of regulation of asset managers exceeds the costs (84%), the regulation of asset managers is achieving the intended objectives (84%) and the compliance function or department is viewed as a business enabler within the asset manager (76%), as supported by the median of 2 or less, which represent the benefits or advantages of regulation. This represents significant findings regarding the perspective of portfolio managers and compliance officers in terms of the advantages and disadvantages of regulation of the asset management industry.

Moreover, 48% of the respondents said that the asset management industry is inclined to grow as a result of regulation. On the other hand, if we are to apply the reverse scoring to the question of whether regulation of asset managers has a negative impact towards economic growth and development of the asset management industry (90%), the results reflect it as a positive for the majority of respondents. These outcomes are to a large extent in line with the findings articulated in the literature review, particularly relating to positive impact of regulation towards the asset managers and the fit and proper requirements for compliance officers in respect of experience, amongst others.

Overall, the results suggest that there is an appreciation of the economic importance and contribution of regulation towards the asset management industry. Equally important is the consistent view of the respondents indicating that the benefits of regulation outweigh the costs thereof.

Figure 27 - Other areas of research relating to regulation of asset managers



The respondents were asked about other areas of research that could be explored further regarding regulation of the asset management industry. Although not all respondents provided answers to this question, of those that responded, most (50%) said they would appreciate more research on the standardization of calculation of management and performance fees, followed by regulation of investment risk (33%) and regulation of hedge funds (16%).

The South African hedge fund industry is currently not regulated. Hedge Fund World (2005: 73-76) suggests that the retail investor's needs for regulation is very different from the sophisticated investor and, as such, it would be disingenuous to apply a "one size fits all" approach. Due to the global nature, the impact of regulation with regard to both local and foreign hedge funds also needs to be addressed. The Financial Industry Regulatory Authority (2016: 01) argues that as much as you cannot eliminate investment risk, there are however two basic investment strategies that can help manage both systemic risk (risk affecting the economy as a whole) and non-systemic risk (risks that affect a small

part of the economy, or even a single company), namely asset allocation and diversification. Moreover, hedging (buying a security to offset a potential loss on another investment) and insurance can provide additional ways to manage risk.

According to Bailey (2008: 33-39), investment management fee structures typically have two parts, namely, a base fee, that's an essential component of the fee structure. If the base fee is too low the presence of a performance fee may give the fund manager incentives to assume unnecessary risks in order to achieve a higher level of fee income, or even to cover the daily running costs of the fund; and an optional performance or incentive fee, usually defined by the benchmark or hurdle rate against which the manager's performance will be measured and the participation rate (the percentage of the performance above the benchmark that the manager will keep). The National Treasury (2013: 22-25) argues that given the complexity of the many charging bases, it is necessary to develop a simple and comprehensive measure of their effect on consumers in order to compare them.

4.5 Conclusion

The regulation of the asset management industry contributes towards enabling economic environment and development of the industry. It can further be concluded that the current legislative universe applicable to the asset management industry is justifiable, beneficial and is achieving the intended objectives, particularly as it relates to protection of clients' investments, enhancing stability in the financial markets and preservation of reputation of the companies or the industry. The costs of regulation of the asset management industry, which entails utilisation of resources such as personnel, time and systems required and limitation on investment freedom and creativity, remain a cause for concern. However, based on the outcomes of the survey, there is adequate evidence to suggest that the benefits of regulation of the asset management industry outweigh the costs thereof.

Chapter Five: Conclusions and Recommendations

5.1 Introduction

This chapter provides a summary of the main findings of the study. It will draw some conclusions on the various aspects discussed in different chapters. Lastly, recommendations are provided relating to the challenges discovered with regard to regulation of the asset management industry.

5.2 Main findings of the study

South Africa is a member of the G20 and as such is subject to Financial Services Assessment by the World Bank. This means that South African companies have to comply with the global regulatory environment. Thus, the adoption and current implementation of Twin Peaks regulatory model in South Africa, seeks to align the regulation of the asset management industry to best international standards. Similar to the regulatory revolution that reshaped the airline and telecommunication industries in the 1980s and 1990s and rewrote the list of winners, new compliance requirements have become a game changer for asset managers.

South Africa’s Asset Management industry is a vibrant, sophisticated environment, with investors having access to a wide variety of investment products, ranging from traditional to alternative strategies. The investment products include securities and instruments such as listed and unlisted equities, bonds, money markets, derivatives, warrants, debentures as well as participatory interests in collective investment schemes. There appears to be a correlation between the growth in the country’s GDP and the AUM in the asset management industry. Economic growth boosts economic activity such as employment creation, and in turn results in increase in capital and investments in the asset management industry. Thus if the economy grows at a faster rate, we are likely to see the AUM in the asset management industry also growing at an accelerated rate.

The outcomes of the study are in line with the conclusion by Jalilian *et al* (2007: 27-29) that the provision of a regulatory regime that promotes rather than constrains economic growth is an important part of good governance. The ability of the state to provide effective regulatory institutions can be expected to be a determinant of how well markets and the economy perform. The impact of regulatory institutions on economic growth will depend on both the *efficiency* of regulatory policies and instruments that are used and the *quality* of the governance processes that are practiced by the regulatory authorities.

The rationale and objectives of regulation, as it pertains to systematic issues associated with externalities, market imperfections and failures, economies of scale in monitoring, consumer confidence and the consumer demand for regulation, would seem to justify the existence and developments of compliance requirements. Regulation must balance the goals of competition and efficiency versus safety and soundness. Regulatory authorities must ensure that the economy is not burdened with unnecessary costs, or that the efficiency of the economy is adversely affected.

While acknowledging that regulatory changes enhance the stability and safety of the financial system, however some companies are struggling with the volume and rapid pace of regulatory changes. The chief concerns are increased costs due to compliance with changing regulation, uncertainty around the requirements for implementing new regulation and apprehensiveness that the overall impact of regulatory changes will hinder the ability of companies to conduct business. The increase in financial regulation have the effect of driving up costs, as specialist staff and systems enhancements are required to meet regulatory reporting requirements.

The escalating levels of financial regulation have resulted in a severe scarcity of specialist expertise in regulation and compliance. Although each organization typically requires four or five employees in these positions, the function is crucial. It is further argued that companies across the financial services sector find it extremely difficult to get suitably

qualified candidates, as staff in these roles require a specific combination of skills and experience, including holistic view of the business. The required expertise include the ability to assess legislation and make appropriate recommendations while taking into account aspects- regulation, compliance requirements, business operations and strategic goals.

Following the financial crisis and political support on both sides of the Atlantic for tighter oversight of financial services, new regulations have been created at a fast and furious pace. The enormous costs of the watershed events of 2007-2009 have forced governments to reconsider how they approach financial sector regulation. Most regulators, particularly in advanced economies, were taken by surprise by the events of 2007-2009 and were unable to anticipate the rise in systematic risk that culminated in the crisis. The South African financial sector did not experience the financial upheaval seen in advanced economies and, as a result, the economy is in a favourable situation to recover from the downturn and emerge stronger than ever before. The South African policy components that protected the country from financial and subsequent sovereign crisis include, amongst others, a sound framework for financial regulation and well – regulated institutions, and have ensured that potential risks were anticipated and appropriate action was taken to mitigate them. South African regulators have generally not taken a light-touch approach (National Treasury 2011: 23-30). Regulatory change will continue to reshape internal policies and procedures.

The University of Cape Town (2014:97-99) found that Regulators believe that one cannot take for granted that even though the recent Financial Crisis did not have significant implications for South Africa, that a Financial Crisis will not affect South Africa in the future. Consequently, higher capital requirements and the reduction of maturity mismatches are beneficial and essential as a preventative measure in the long-term. In the short-term, companies across the Financial Services sector view increased regulation as an additional tax. Thus, overall, Regulators believe that regulation is the glue that holds

the Financial Services sector in South Africa together and the associated costs of regulation contribute to the stability of the financial system.

Notwithstanding the regulatory universe applicable to the asset management industry which is wide and far reaching, the outcomes of the research indicate that the majority (88%) of the asset managers spent most of the time on the FAIS Act, in terms of compliance monitoring/ activities. The severe nature of consequences for failure to comply with the FAIS Act dictates that more resources and time must be channeled towards monitoring compliance with this legislation. The FAIS Act provides that the Regulator (FSB) may take regulatory action (e.g. suspend/ withdraw the FAIS license, issue monetary penalties, imprisonment) in the event that the FSP fails to comply with the provisions therein. Thus, the consequences of non-compliance may be very expensive, compared to the costs of compliance.

The main findings of the research can be summarized as follows:

- The results suggest that there is an appreciation of the economic importance of the asset management industry, as a creator of employment and its effect on the growth and development of the South African economy in general.
- The regulation of the asset management industry contributes towards enabling economic environment and development of the industry;
- The current legislative universe applicable to the asset management industry is justifiable, beneficial and is achieving the intended objectives, particularly as it relates to protection of clients' investments, enhancing stability in the financial markets and preservation of reputation of the companies or the industry;
- The fact that the outcomes of the research shows that the majority (88%) of the respondents believe that the regulations applicable to the asset management industry are fair/good, compared to 12% that indicated that the asset managers are under/over regulated, signals a vote of confidence towards the extent of regulation, by some of the key stakeholders (i.e. portfolio managers and compliance officers);

- The research outcomes have cited the main benefits of regulation of the asset management industry to be financial markets stability, protection of consumers' investments, preservation of the reputation and integrity of the companies/ industry and transparency in the market place;
- The costs of regulation of the asset management industry, which entails utilisation of resources such as personnel, time and systems required and limitation on investment freedom and creativity, remain a cause for concern. However, based on the outcomes of the research, there is adequate evidence to suggest that the benefits of regulation of the asset management industry outweigh the costs thereof.

5.3 Recommendations

The outcomes of the research suggest that under the new paradigm, success will be determined by how asset managers can solve several key challenges such as enhancing operational efficiency, complying with the complex regulatory environment and meeting the changing customer expectations.

The following compliance strategies are recommended in order to thrive in the current regulatory environment and are rated amongst the best by the survey participants:

- Adoption of a top down approach from Board of Directors and Senior Management to the rest of the employees, to ensure adequate support and buy in towards regulation and compliance function;
- Employment of adequately experienced compliance officers;
- Having regular meetings with regulators, including affiliation with professional industry bodies to keep abreast of regulatory developments;
- Outsourcing of the compliance function to external experts to maintain independence from management;

- Adoption and implementation of a risk based approach to regulatory compliance, such that more resources could be dedicated towards areas that pose significant risk to the organisation; and
- Incorporation and integration of regulatory requirements into business processes, including providing training and workshops to employees on a regular basis.

The outcomes of the research further point to the sentiments shared by Ernest and Young 2014, on the global wealth and asset management industry outlook, which predict that the new regulatory environment will have a profound impact on the entire asset management industry's business development and strategic planning. Some key points for survival will include the following:

- Data- Asset management firms have entered a new era of big data, again following the footsteps of large retailers and airlines that command a global IT infrastructure that is often more sophisticated than the data systems of many sovereign governments. Asset managers will eventually be compelled through regulation to store, manage and disclose more client-specific data related to portfolio holdings. Most regulatory requirements focus on sources and retrieval of data held by the enterprise, as well as data held by external service providers on behalf of that enterprise. Increased demands for data gathering will further incentivize asset managers to revisit outsourcing;
- Disclosure and transparency- An unprecedented level of disclosure to regulators and investors has become the norm. For new regulatory filings, asset managers must often disclose data that once was considered confidential or proprietary;
- Redesign operating model- Many entrepreneurial and proactive asset managers will look upon the new regulatory environment, understand the secular trend impacting margin compression and demands for big data, and seize the opportunity to implement a new operating model from the ground up. The complex chaos of the rapidly changing regulatory environment affecting the entire industry will prove to be an opportunity for highly adroit asset managers. They will come out of the restructuring process with an enhanced competitive advantage in terms

of higher levels of productivity, efficiency, flexibility and, ultimately lower operating costs; and

- Prepare bucket number two- One key challenge will be to implement systems that not only comply with current regulations but also are readily scalable for unknown future demands. While designing a new operating model should focus on current regulations and neat-term filing deadlines, there should be plans for a "bucket number two": data gathering required for regulations that are not finalised or that asset managers have not yet assessed. The asset managers recognises the challenges and the changing dynamics of managing client's investment portfolio and thus anticipate regular and rapid regulatory developments and changes that seeks to respond to such challenges and are relatively ready to adopt and implement the regulatory changes.

Given the poor record of asset management industry pundits during the 2007-2009 financial crisis, making predictions about the direction of the global wealth and asset management industry comes with a considerable degree of risk. However, we can arrive at several broad conclusions about how recent trends will play out. Compliance is "core"- The new era of compliance will force asset managers to focus on an enterprise-wide integration of business strategy and not simply short-term tactical solutions. Success in the new environment will require establishing new operational process with ownership from the business and compliance alike, as well as a substantial investment in data architecture and review of the business operating model. The investment in data architecture will not merely be a short-term exercise in meeting filing deadlines, but rather a smart long term strategy to enhance growth opportunities and find new markets. For asset managers that effectively meet the challenge of the changing regulatory environment, investments in infrastructure and implementation of an enhanced operating model will provide opportunities to enhance profitability and ensure growth.

Moreover, the role of data architecture and IT infrastructure will increasingly become a "business problem", taking a prominent seat squarely in the front office and the C-suite,

particularly in wealth management given the trend toward greater personalisation of service offerings and prioritisation of enhancing clients relationships, as well as regulatory requirements-client specific data will become a valuable core asset (Ernest and Young 2014: 26-29). Lastly, the asset management industry will grow and shrink. In terms of AUM, the industry will continue to grow steadily and keep pace with global economic growth. However, the headcount and profitability margins for most asset managers, particularly for all but the most innovative players, will narrow.

The identified areas of research that could be explored further regarding regulation of the asset management industry relates to exploring the feasibility of quantifying the costs of compliance in the form of compliance systems utilized, employment of compliance personnel, compliance training to employees, integration of compliance into business processes, etc. Moreover, other areas of research for consideration relates to the standardization of calculation of management and performance fees as well as regulation of hedge funds and investment risk. Lastly, there is also a possibility of exploring big data and being innovative in future studies, as it has greater impact on the regulatory environment.

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Appendix 1 – Survey Questionnaire

QUESTIONNAIRE FOR ASSET MANAGERS (FAIS CATEGORY II FINANCIAL SERVICES PROVIDERS) PARTICIPANTS

For purposes of this research, Asset Managers are defined as FAIS Category II Financial Services Providers

Please indicate the most accurate answer by ticking the appropriate box/es.

PERSONAL INFORMATION

1. Please indicate your gender

Male	
Female	

2. Please indicate your role in the organization?

Compliance Officer	
Key Individual/ Portfolio Manager	

3. Please indicate your highest academic qualification?

Matric or lower	
Diploma	
Degree	
Honours	
Masters	
Others, please specify………….	

4. How many years of compliance experience or investment management do you have in the asset management industry?

Less than 3 years	
Between 3 and 5 years	
Between 6 and 10 years	
More than 10 years	

5. How many years have you been with your current employer?

Less than 2 years	
Between 2 and 5 years	
Between 6 and 8 years	
More than 8 years	

6. Please indicate whether you (or your organization is) are a member/ affiliate of the following professional industry bodies?

Compliance Institute of Southern Africa (CISA)	
ASISA	
Others, please specify	
None	

ASSET MANAGER INFORMATION

7. For how long has the company been operational?

For 2 years or less	
Between 3 and 5 years	
Between 6 and 8 years	
Between 9 and 10 years	

More than 10 years	

8. What is the value of your company's assets under management (AUM), as at 31 December 2014?

Less or equals to R500mil	
Greater than R500mil and less than R1bn	
Greater than R1bn and less than R5bn	
Greater than R5bn and less than R10bn	
Greater than R10bn and less than R15bn	
Other, please specify……..	

9. In what geographic market(s) does the company invest? (Tick more than one if applicable)

South Africa	
Other African Countries	
Europe	
United Kingdom	
United States of America	
Rest of the World	
Others, please specify	

REGULATORS

10. How would you rate the working relationship with (or assistance/ guidance received from) Regulators (i.e. Financial Services Board and Financial Intelligence Centre)?

Poor	
Average	
Good	
Very Good	
Excellent	

11. How many on-site reviews/ inspections did the Regulators (FSB and/ or FIC) perform in your company during the past 5 years?

None	
1 to 2 times	
3 to 4 times	
5 to 6 times	
More than 6 times	

COMPLIANCE FUNCTION

12. How many compliance officers (personnel) do you have that perform compliance functions in your company?

1 - 2	
3 - 4	
5 - 6	
7 - 8	
More than 9	

13. Is your company's compliance department adequately staffed to efficiently and effectively perform compliance functions?

Yes	
No	
Maybe	

14. What strategies are pursued/ adopted to enable your company to thrive in the current regulatory environment?

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…………………………………………………………………………………………………
…………………………………………………………………………………………………
………………………………………………………………………………………

15. The establishment of a compliance function and monitoring within your asset manager is effectively the result of the following: Please choose one option for each statement below.

	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
The appreciation of compliance by the Board and/ or Senior Management					
Severe regulatory penalties that may be imposed for failure to comply					
Mitigation of reputational risk					
The value added by regulatory compliance towards the business activities					
Understanding of the benefits of compliance					
Understanding of the costs of non-compliance					
Contribution of regulations towards making the financial system secure					
Serve to maintain a good relationship with the Regulators					

REGULATORY COMPLIANCE

16. Which of the following asset management related legislations are applicable to your company? Please tick the applicable option/s.

FAIS Act	
Companies Act	
Financial Markets Act	
Financial Intelligence Centre Act	
Pension Funds Act	

17. Please indicate which one of the following legislations do you spend **most of the time** on, in terms of compliance monitoring/ activities?

FAIS Act	
Companies Act	
Financial Markets Act	
Financial Intelligence Centre Act	
Pension Funds Act	

18. Please indicate which one of the following legislations do you spend **the least time** on, in terms of compliance monitoring/ activities?

FAIS Act	
Companies Act	
Financial Markets Act	
Financial Intelligence Centre Act	
Pension Funds Act	

19. What do you believe is the purpose/ objective of regulation of asset managers?

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20. What are the costs and benefits of regulation of the asset management industry?

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21. Do you believe that the legislative or regulatory universe that is applicable to the asset managers is justifiable?

Yes	
No	
Maybe	

22. To what extent is regulatory compliance integrated into the business processes within your company?

Poor	
Average	
Good	
Very Good	
Excellent	

23. What is your view on the extent of regulation of asset managers?

Over regulated	
Under regulated	
Fair	
Good	
Excellent	

24. Please indicate to what extend do you agree or disagree with each of the following statements: Choose one option for each statement below.

	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
The benefits of regulation of asset managers exceeds the costs					
The regulation of asset managers is achieving the intended objectives					
Regulation of asset managers have negative impact towards economic growth and development of the asset management industry					
Regulation of asset managers have positive impact towards economic growth and development of the asset management industry					
The asset management industry is inclined to grow as a result of regulation					
Regulation of asset managers is contributing to the enabling economic environment					
The compliance function or department is viewed as a business enabler within the asset manager					
The compliance officers of the asset managers are generally sufficiently knowledgeable and experienced regarding					

regulations affecting the business.					

CONCLUSION

25. What other areas of research do you think should be explored in the regulation of asset managers? (please list/explain)

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    ………………………………………………………………………………………………
    ………………………………………………………………………………………………
    ………………………………………………………………………………………………

26. Should you have any comments on the regulation of asset managers or any suggestions regarding my research, please comment here:

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    ………………………………………………………………………………………………
    ………………………………………………………………………………………………
    ……………………………………………………………………………………………..

27. Would you like a complete digital copy of my dissertation?

Yes	
No	

Thank you for your time and effort in completing this questionnaire.