

A survey into the Italian hedge
fund market, from a participant's
perspective



Simmons & Simmons

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Introduction

During the last ten years we have been witnesses to the transformation of an exclusive group of managers, providing investment management reserved to a few investors, into a well-established industry, recognised and widespread on a global scale.

In 1996 there were only 2,700 hedge funds globally managing approximately US\$300 billion. Today, the number is closer to 8,600 funds managing assets of approximately US\$1.2 trillion. Estimated asset growth for the year 2006 is in excess of 20%.

The global scale of the industry has changed also: the majority of managers are still located in the USA but almost the same number now exists in Europe (which today represents approximately 30% of the global market) and in Asia, Latin America and South Africa.

This growth is not due to accidental development, but to the interaction of different factors that have contributed to stimulating the creation of today's market and formed the foundations for future developments.

The knowledge and diffusion in the use of derivative instruments has, in fact, favoured the creation of new strategies; market globalisation and technical development has improved the informative efficiency in the markets. This has eliminated the large scale speculation that characterised the 1980s and early 1990s.

The increased presence of institutional investors (who now represent 60% of all hedge fund investors), that require portfolio transparency, more sophisticated risk management instruments, counterparties of elevated standing and risk objectives/fixed yield; these have all contributed in bringing the industry to the qualitative standards that we see today.

An epochal event was the Long Term Capital Management débacle of 1998, which led to the creation of the modern hedge fund industry. The attention it generated on a worldwide scale has actually acted as a stimulus to the general interest shown towards these kinds of investments. It also provided an important lesson to investors, regarding:

- the necessity to develop an articulated methodological approach (*due diligence*); and
- the ability to verify investment processes and evaluate the management methodology of the risks adopted by the hedge funds.

Since then, we have seen the growth in the number of institutional investors that, thanks to continued investment and dedicated professionalism, have contributed to the development of independent providers able to guarantee the correct operation of the industry: legal, administrative, and valorisation services, custody and stock loan.

But the factor that probably has determined more than others the spread of the hedge fund product on a global scale has been the increasing involvement of the supervisory authorities: to date the majority of the European Countries and all of the main international investment markets (Hong Kong, Japan, United Kingdom, United States, etc.) have adopted regulation of hedge fund managers.

In this regard, Italy is one of the pioneers of the European industry, having adopted from 1999 an *ad hoc* material regulation. Such farsightedness has allowed for the creation of a system characterised by:

- elements of solidity and transparency which are extremely necessary to investors;
- a regulatory body that has enabled Italy to enjoy greater development of its industry than other countries who have only recently made or begun such a process; and
- a regulatory system which enables to the identification of each hedge fund manager, every single hedge fund and its assets under management. This is due to the legal requirement at the registering stage: each manager is required to apply as a “hedge fund company” and each product is to be regulated under the “hedge fund regulation” ,

This innovation has led to important growth for the Italian hedge fund industry: with assets exceeding €18 billion (€18.3 billion as at February 2006). In fact, Italian companies manage over 5% of the total assets invested in Europe. Of this figure, however, only 3% (€570 million as at February 2006) are managed by “single manager” hedge funds: this means that 97% of assets are managed through Funds of Hedge Funds (multi-manager hedge funds).

Such “asymmetry” was the inspiring reason for the research carried out by AIMA and Simmons & Simmons. Our aim was to collect the most relevant aspects that have led to the prevailing development of multi-manager products (Funds of Hedge funds) to the detriment of the growth of a “pure” hedge funds market.

From the research carried out, a homogeneous picture emerges, in which the need to improve the perception of “speculative” (hedge) Italian funds is recognised as is the desire to encourage greater competitiveness of Italian funds on an international level. Respondents wish to see the domestic industry being encouraged to develop. They also seek the introduction of different and specific regulations for funds of funds versus “pure” hedge funds.

There are factors which support the need for an innovative push, capable of rendering the alternative investment industry more competitive. The new Governor of the Supervisory Authority commented on the development of the managed savings it provides. During an official speech held in Cagliari (the FOREX meeting) it was highlighted that savings are a fundamental resource for the development of the Italian economy and efficient

management is a competitive challenge as well as an opportunity for growth. Among the leading factors necessary to reach a level of growth proportionate to the actual competition on the global markets, a system is hoped for where there is greater independence of asset managers.

Our view is that the Speculative SGR [see definitions on page 7] already represents one of the best examples of independence in the Italian market characterised by:

- the separation of the functions imposed by the regulation;
- the articulate organisational structure;
- the specialization of the company's focus;
- the level of independence in this more than in any other asset management sector.

We can also focus on the fact that common to successful hedge funds is the entrepreneurial (independent) nature of the business and the constant production of absolute yield. Additionally, because this business' target is centred on efficiently managing financial assets (providing total returns) we believe this to be a best example of how the hedge fund industry can meet on-shore asset management demand.

In this regard, we believe that the experience, know-how and culture developed by the Italian investors in the use of the alternative instruments could represent a solid base on which future growth can be expected.

Massimo Maurelli

AIMA Council Member - Italy

Expression of thanks

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Structure and objectives

This document sets out the results of a survey carried out on the Italian (hedge) funds' market by AIMA (the "Alternative Investment Management Association"), an international association specialising in the hedge fund sector, in collaboration with the international law firm of Simmons & Simmons.

The survey's aim was to:

- solicit the input of leading practitioners in the Speculative Funds sector on the status of the Italian market. We wished to obtain their thoughts on the market's development perspectives; and
- investigate any issues that influence its current effectiveness.

A questionnaire was submitted to all the Speculative SGRs authorised by the Italian regulatory authorities. Its aims were to obtain:

- evaluation of and expectations as to the future of Speculative Funds in the Italian marketplace;
- opinion on the consistency and completeness of the relative laws in force in this regard, above all in relation to those concerning the protection of investors;
- characterisation of the instruments suitable to support the growth of the domestic Speculative SGR market, analysing the reasons for its lack of development;
- evaluation of the entrance constraints (dimensional limits, solicitation prohibition) in relation to the Speculative Funds by the relative regulations;
- opinion on the "alternative" or "indirect" subscription methods of a Speculative Fund; and
- insight from those involved in the Funds' management process.

This document seeks to demonstrate two distinct needs:

- to provide an objective picture of the Funds market and of the expectations of its participants, and
- to present the participants' points of view on the recurring problems with operational procedures.

For clarification purposes, we have analysed and condensed the collective input from all participants.

Moreover, the Work Plan on the last page gives an indication of possible intervention areas highlighted by the participants.

DEFINITIONS

SPECULATIVE FUNDS

Hedge Funds in Italy are regulated under a common definition: "Fondi Speculativi" (Speculative Funds). Such definition does not differentiate between Single Manager Hedge Funds and Funds of Hedge Funds. In the document when referring to "Speculative Funds", no distinction is made between single managers and fund of funds. Given the above, it is important to observe that almost 97% of the hedge fund market in Italy today is represented by Fund of Funds. This means that just 3% of the Speculative Funds are single-manager hedge funds.

SPECULATIVE SGR

Asset Management companies in Italy are regulated by the Bank of Italy and COSOB, depending on the type of funds they want to distribute. In order to manage and distribute to the public a Speculative Fund, an Italian asset management company must be authorised solely for this specific purpose. Thus such companies are identified as "SGR Speculativa" (Speculative SGR). Those asset management companies whose objective is to manage and distribute Traditional Mutual Funds are simply identified as SGRs (Società di Gestione del Risparmio).

Executive Summary

From 1999 to date, the Italian hedge funds' market has seen exponential growth, both in terms of the number of speculative funds (161 products at the end of 2005: a 23% increase in respect to the previous year) and the dedicated SGR (33 speculative SGR). These funds manage €17.3 billion as at 31 January 2006; a growth of 41% from 2005.

Nevertheless, this is still a niche sector when compared to most traditional forms of collective portfolio management and demonstrates, if considered on an international level, a very small part of the global industry. (There were approximately 8,600 recorded hedge funds with total assets of in excess of US\$1trillion dollars in 2005).

This AIMA initiative was borne from the desire to provide a picture of the Italian hedge fund market; of its expectations and developmental needs.

There were three phases employed:

- a face-to-face discussion with Italian AIMA member companies of the overall objectives of this study;
- the creation of a questionnaire designed to study in detail the most technical aspects and effectiveness of the speculative SGR industry, which would have the aim to identify the elements considered necessary for further industry development;
- the collection and collation of the information, comments and suggestions made by participants, of which this document is the result.

The questionnaire was split into seven macro subjects, which each contained starting points and specific questions. We asked for constructive criticism and an elevated technical content from the companies interviewed.

In numerical terms, 74% of the SGR to whom the questionnaire was sent replied, which represents 82% of the total hedge fund assets managed in Italy.

With regard to the macro subjects proposed, we highlight the following:

I. General Situation of the Italian industry

General picture: the overall evaluation of the Italian alternative investment market is positive. At the same time, the following negative factors have been identified:

- *the specifics and the rigidity of the distribution system;*
- *the prevailing development of the funds of funds market and marginal role for single hedge fund managers;*
- *the surplus of the offer of low volatility funds of funds with respect to those of high volatility;*
- *the high level of commission.*

- **Legal framework:** having mainly expressed a positive opinion on the effects of the regulation on the Italian hedge funds' market, the companies have not hesitated to point out that the legal subscription limits (€500,000) and 'cultural' aversion by investors to risk are a limiting factor for the diffusion of Speculative funds in the Italian market.

- **Competitiveness:** in terms of competitiveness and development, the absence of specialist on-shore knowledge is considered as a hindrance to the use of Italian funds offshore. The companies note the lack of "quality" newcomers to the Italian marketplace in terms of expertise. This inevitably limits competition in the market. The increase of onshore ability and skills would, in fact, enable the increase in interest from foreign markets which in turn would promote the entry of new independent managers.

- **Putting things into perspective:** the anticipated development trend is measurable only in the medium/long term period. Within this time frame the following relative provisions should be noted:

- *Increase in institutional investor appetite;*
- *The possibility for managers to guarantee a steady return with a consistent increase of investors' confidence while increasing assets managed;*
- *The growth of liquidity and the convergence towards management techniques that are more similar to those of the traditional industry;*
- *The "independent" management of assets that is carried out without any recourse to external advisers.*

II. Structure of Italian law

General picture: the respondents consider that current national legislation provides an adequate level of investor protection.

Putting things into perspective: respondents noted the strain on the market due to current investor perceptions partly due to the terminology; some of the proposed solutions highlight the absolute necessity to amend the name of the “Speculative funds”, so as to highlight, rather, the “hedging” nature of the funds.

- **Identification:** the perception needs to be changed by differentiating between pure fund (*single manager*) and funds of funds (*multi-manager*). Currently, funds of hedge funds are erroneously regarded as highly risky due to their categorisation as Speculative funds.

- **Non-harmonised Funds¹:** the opinions are conflicting in regard to the new provisions introduced by the Bank of Italy in relation to the non-harmonised open funds, which can invest up to 20% into Speculative funds:

- *On the one hand the new provisions are seen as an opportunity for further growth.*
- *On the other hand there seems to be an opinion that underlines the lack of development of the non-harmonised funds on the Italian market - they form only a marginal percentage of the total asset management industry - and the hybrid nature of the management as defined by the new legislation..*

Generally the companies consider that it would have been preferable to face the problem of the **splitting of the quotas** of the speculative funds, ie clearly differentiating between single fund and fund of funds investments.

III. Type of products offered on the Italian market

Actual picture: the absence of a fast and efficient development of the domestic single manager hedge fund market is due to exogenous and endogenous factors.

Exogenous factors: (i) existence of barriers due to cultural perception thus acceptance of single manager funds; (ii) lack of requests from institutional investors; (iii) absence of appropriate management ability; (iv) rigid regulation; (v) mechanisms of taxation.

¹ Non-harmonized open ended Funds: open ended mutual funds which can invest up to 20% of their assets into Speculative Funds

Endogenous factors: (i) difficulty of outlining from a legislation point of view the administrator/manager/prime broker relationship; (ii) highest level of diversification guaranteed by the funds of funds; (iii) extremely onerous establishment costs of the speculative SGR; (iv) the benchmark culture that has limited the creativity of managers and that has not motivated the entrepreneurial profile of this type of investment.

- **Putting things into perspective:** key factors that can determine future growth of the hedge funds' market in Italy are numerous. The companies have, in particular, set out the following:
 - *The need for independent initiatives;*
 - *This flow of expertise and skills from the banks' proprietary trading desks into the asset management industry*
 - *Existence of "incubator companies" that support the start up of funds providing infrastructure and services (back office, marketing, legal, sales, etc.)*
 - *Exchange of expertise between traditional managers and managers of Speculative Funds; and*
 - *Investing in people and technology in order to develop stronger and better quality companies*
- **Legal framework:** the companies agree on the need to distinguish the regulation of single manager hedge funds from funds of funds. The differentiation should operate in regard to all thresholds and investment limits.

IV. Specific limits imposed by the regulation on the Speculative Funds

- **Limits on the number of participants** (200): it is considered, by all of the companies, inadequate and easily avoidable. Such constraint actually generates extra costs for SGR thus reducing returns for investors.
- **Minimum investment threshold:** the companies agree that such a threshold is not necessary in regard to fund of funds investment. Moreover, such provisions do not offer sufficient protection to the investors; the threshold does not in fact guarantee that the client is diversifying its investment (and that it is not investing all wealth in a single product).
- **Splitting prohibition of the quotas:** the common opinion of the respondents is that the splitting prohibition should be eliminated.

V. Comparison with other Countries where hedge funds are marketed

Solicitation prohibition: those participants that consider that it is appropriate to revise the solicitation prohibition comment that the prohibition limits investor education of such products. Alternatively, any solicitation prohibition could be measured on the characteristics of the investors. The companies propose, moreover, to “replace” the prohibition with the provision of greater informative obligations on the risks of hedge fund investment.

Obstacles for the marketing of the Italian speculative funds abroad:

- *the domestic taxation mechanism;*
- *the lack of credibility of Italy;*
- *the rigidity of the legislation.*

VI. Offer of structured products

- With regard to the investment in structured products, as an alternative to the direct subscription to quotas of speculative funds, some of the companies agree that such instruments are an investment opportunity, useful for those investors having specific needs (e.g. insurance companies).
- Conversely, other respondents believe that a principal guaranteed note is not appropriate for multi-manager funds of hedge funds because of the lower risk profile that the funds of hedge funds already have. ,
- Some participants expressed the need to amend the provisions on structured products so as to permit the “construction” of such products indexed to speculative Italian funds and make them available to retail clients.
- In this regard, a further requirement that was strongly voiced was the need to avoid “legal arbitrage” and, therefore, a most favourable and less rigid market. Today while some foreign players can sell structured notes through “passport products”, Italian domiciled companies cannot. Such a situation creates a notable penalty for Italian hedge fund Companies (Speculative SGRs), which are not allowed to sell their products under the “structured notes umbrella”.

VII. The relationship between SGR and third party subjects

- Entrusting the NAV calculation to the custodian bank is considered the best solution by the majority of the participants, even if the specific solutions adopted are different, in practice. The main advantage of entrusting this task to the custodian bank is recognised in the independence of a third party status ("*terzietà*") and the further comfort that this can provide to the investor.
- The possibility of taking advantage of foreign administrative services is desired by all participants. This could bring further inflow of knowledge and expertise to Italy.
- The companies highlight that a business model which tends not to outsource management functions guarantees full control of the investment process. Thus a business model where the selection of hedge fund managers is done independently and not driven through any external advisors is the most efficient.

VIII. Development needs for the growth of the Italian market

- All of the Speculative SGRs highlight the need to improve the fiscal regime. In particular, they require a changing of the mechanisms employed in order to compete with international players.
- The companies require a change from the current name "speculative funds" ("*fondi speculativi*") into one which highlights the "hedging" characteristics of these products
- The name is considered misleading in that it presents the product as being highly aggressive.

The final part of the document is a "Work Plan". Three macro areas are summarised (*Strategy, Regulations, Structure and Resources*) in which we present possible solutions to the issues addressed.

Survey results

I. From 1999 to date, the Italian hedge funds market has recorded exponential growth, both in terms of the number of speculative funds and dedicated SGR. Nevertheless, this still represents a niche sector with respect to the most traditional forms of collective portfolio management and, if considered on an international level, the relevant dimensions are still of very small significance.

- *How would you evaluate the status of the Italian hedge fund industry?*

In only a few years since its commencement, one can evaluate the Italian hedge fund market situation very positively.

The participants have highlighted how the hedge fund market in Italy still offers great opportunities despite certain legislative barriers. The key reason is that, to date, these Funds have been of interest to *High Net Worth Individuals*, and not to the institutional and retail market yet.

The following points are given by participants as indication of positive market development:

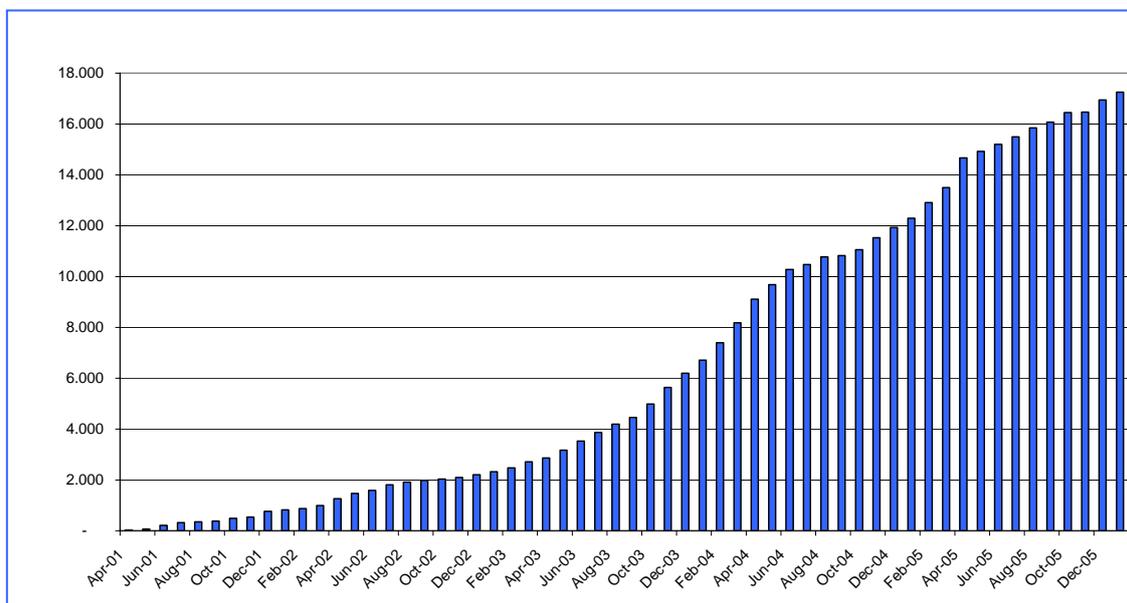
- growth of assets;
- positive performance;
- active management of all risks associated to the business;
- regulated and progressive growth of the market partly due to the severity of the authorisation process imposed by the Supervisory Authority;
- the success of independent players, in a market traditionally dominated by banks and insurance companies.

At the same time the following negative factors have been identified:

- the specifics and the rigidity of the distribution system given by the minimum investment (€ 500,000) required to invest into speculative funds and the prohibition of marketing of the products;
- the prevailing development of the funds of funds market, resulting in a marginal role for direct managers (also due partly to the natural concentration of hedge fund managers outside of Italy);
- the surplus of low volatility funds of funds; and
- the high fee levels.

However, despite the market having noted a temporary slowdown phase, the common view is that the market is undergoing a consolidation phase, continuing to provide strong products and strategy innovation.

Figure 1: Italian hedge fund industry asset growth (€billion)



- What are, in your view, the most important strengths and critical factors of the Italian market in relation to speculative funds? How can the use of speculative funds within traditional management be encouraged?

In the opinion of the participants, the regulation of speculative funds is both a strength and a weakness.

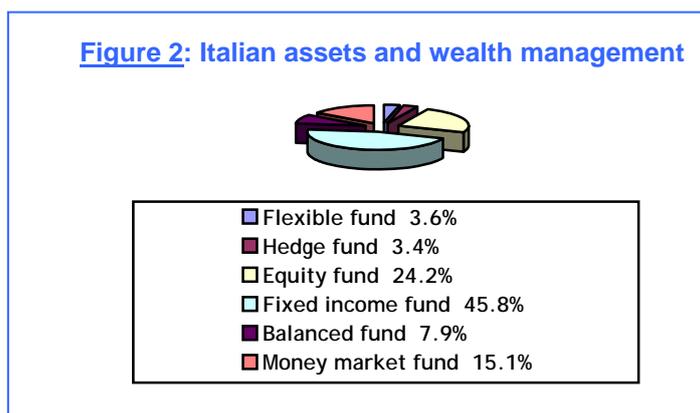
Regulation further enhances the solidity of those companies managing speculative investments and imposes essential transparency standards for the protection of investors.

While welcoming this positive aspect, the participants have not hesitated to point out that the combination of 'cultural' risk appetite/aversion by investors and the legal limitations contribute to the lack of penetration by these Funds into the Italian market.

The main desire seems to be for the effective promotion of the capacity and ability of this specialist fund management skill, which has not been sufficient to date.

In particular, participants note an absence of specialist knowledge in Italy. They cite the difficulty in forming a solid national background in this field due to the migration of most experienced managers abroad. This inevitably results in a lack of “quality” Italian managers, resulting inevitably in a less competitive market.

An increase in hedge fund management experience would improve competition, enable managers to attract more foreign investment and attract new, independent fund managers.



Moreover, the increase of Italian specialised knowledge would contribute to the reduction of dependency on non-Italian managers.

Further critical factors identified are:

- the lack of specialist single strategy hedge funds;
- the raised minimum investment level which makes it difficult for a fund to break even;
- the prohibition to split the quotas of such funds, thus the difficulty of accessing the retail market given the minimum investment level of 1 quota (€ 500,000)
- substantial illiquidity of the investment (as opposed to traditional asset management).

- *What are your expectations in relation to the market's evolution in the short, medium and long term? (Please consider management strategy, net collection and/or type of clientele.)*

The common view is that developments are measurable only in the medium to long term.

Within this time frame, participants expect to see:

- institutional investor growth in appetite for different investment styles to traditional assets;
- the potential for managers to improve and enhance their reputation with institutional and retail investors;
- within the fund of funds sector, increased strategy specialisation, by sector and/or geographical area, and the launch of the *multi-manager style products*;

- growth of liquidity for investors and a convergence of management techniques more similar to those of the traditional industry;
- “internal” management of the fund of funds product, that is carried out without any recourse to external advisers.

Table 1: Italian managers

Akros Hfr A.I. Sgr	Gr. Credit Agricole - Gr. Banca Intesa
Albertini Syz I.A. Sgr	Hedge Invest Sgr
Aletti Gestielle Alt. Sgr	JP Morgan I.A. Sgr
Azimut Capital Management Sgr	Kairos A.I. Sgr
Bim A.I. Sgr	Lyxor
Bipitalia Alternative Sgr	Morgan Stanley Sgr
Capitalgest A.I. Sgr	Mps A.I. Sgr
Capitalia I.A. Sgr	P&G Sgr
Cartesio A.I. Sgr	Pioneer A.I.M. Sgr
Dueemme Hedge Sgr	Pirelli Re Opportunities Sgr
Dws A.I. Sgr	Pwm Sgr
ErseI Hedge Sgr	Ras Ai Sgr
Euromobiliare A.I. Sgr	Sanpaolo Imi A.I. Sgr
Finanziaria Internazionale Ai	Ubs Ai Italia Sgr
Generali I.A. Sgr	Unifortune Sgr
Global Selection Sgr	Zenit A.I. Sgr
Gottardo A.M. Sgr Alt.	

II. Italy boasts of one of the most complete hedge fund regulatory regimes, following the introduction of the note provisions relating to the Bank of Italy's Regulation of 14 April 2005.

- Do you consider that national legislation offers an adequate level of investor protection? What initiatives could be taken to improve the perceptions of hedge funds?

A significant number of participants consider that the national legislation ensures an adequate level of investor protection.

Opinions in this regard seem to be in favour of the scheme designed by the regulators as well as the specialisation level that it provides for all technical aspects.

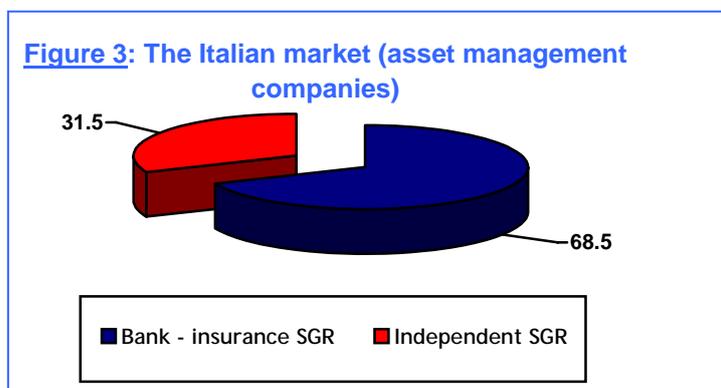
Some participants highlighted the negative effects that excessive deregulation has caused in other countries - noting particularly the US hedge fund marketplace which has suffered from fraud and other unprofessional acts in the past.

In order to increase the sphere of investors into speculative products, the participants identify an urgent need to create solutions aimed at improving the perception of the product.

One of the proposed solutions highlighted is the necessity to amend the phrase "Speculative funds". A new phrase would reflect the "*hedging*" policy (*i.e.* covering of the risks) that characterise the products while not possibly misleading potential users as to its investment aims.

In the meantime, the phrase and regulatory provision do not make clear a distinction between a pure fund (*single manager*) and fund of funds (including *multi-manager*). This may result in a perception that funds of funds may be highly risky.

Further to the above mentioned "formal/promotional" interventions, more than one of the



Companies involved in the survey recognises the need to improve the level of information on such products, through a greater number of the methods and by creating *standard* communication networks.

Again, the need to eliminate the prohibition of splitting the quotas and the possibility to invest such quotas through single client's discretionary accounts was highlighted.

- *Do you consider the development opportunities offered by the Bank of Italy's new provisions significant - in particular the regulation of non-harmonised domestic funds², authorised to invest in speculative funds?*

Opinions on this topic are conflicting.

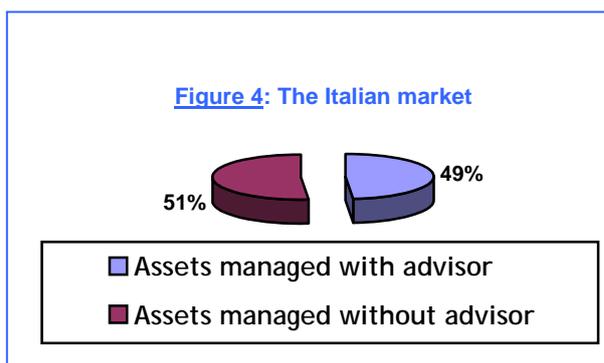
On the one hand, the new provisions are seen as an opportunity for further growth of speculative funds through the shield of non-harmonised funds. In particular, significant benefits are identified in terms of opening the retail market: the diversification of distribution channels for such investments should increase appetite by the potential market, which will lead to a positive impact on assets under management. Also,

² Non-harmonised domestic funds: a category of funds which can invest up to 20% of its assets into Speculative Funds

participants are keen that retail access to these types of products is provided through the asset management Companies.

On the other hand, there seems to be an opinion that underlines:

- the lack of development of the non-harmonised funds within the overall Italian fund marketplace;
- the hybrid nature of the product which creates a *mismatch* technique of the liquidity (daily/weekly NAVs required by the non-harmonized funds VS a monthly NAV for Speculative Funds).



Participants note that it would have been preferable to face the problem of the splitting of quotas of speculative funds.

- *What are the main advantages and disadvantages to this legal development?*

The new category of funds defined by the Bank of Italy's provisions, non-harmonised open funds that invest in speculative funds, seem to allow for a more widespread distribution of speculative products

The aggregate maximum limit of investment (20%) in speculative funds imposed by the provision is considered to be limiting. Such a limit reduces the impact that the returns of the speculative product could have on the investor's portfolio. This would be particularly noticeable in downward trending markets.

Several participants pointed out the operational challenges in connecting the "traditional" nature of the investment with the "speculative" nature of the funds. In particular, they noted the criticisms regarding the frequency of the NAV calculation: speculative funds usually have a monthly frequency, whereas the traditional funds have a daily or weekly frequency.

III. The Italian market is still characterised as a multi-manager hedge fund (fund of funds) industry, waiting for the much hoped-for development of single manager hedge funds.

- *What are, in your opinion, the reasons why the development of the domestic single manager funds market has slowed down?*

The absence of a fast and efficient development of the domestic funds market is due to exogenous (environmental) and endogenous (investment management) factors.

Amongst the exogenous factors, the speculative funds' environment is influenced by a number of factors, in particular:

- A lack of financial knowledge and risk-taking culture which creates entry barriers for *single manager hedge fund products*,
- lack of institutional investor appetite;
- absence of appropriate on-shore management experience;
- inflexible regulation.

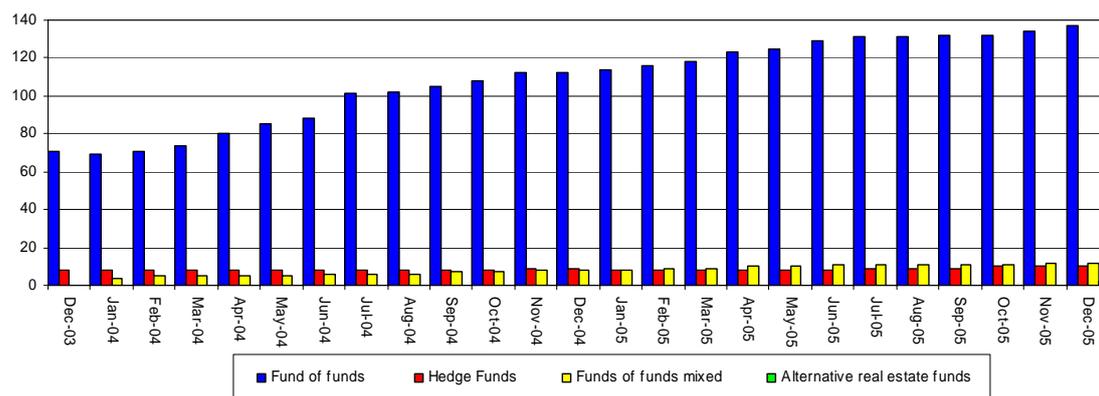
Considered as a whole, these issues contribute to rendering the Italian market less favourable than foreign markets, such as the UK and Switzerland.

Considering the endogenous factors, the interest is focused:

- i. on the difficulty of outlining from a legislative point of view the administrator/manager/prime broker relationship;
- ii. in terms of costs, on the consequences deriving from the complexity of the financial infrastructure of the speculative managers;
- iii. on the highest level of diversification guaranteed by the funds of funds;
- iv. on the extremely onerous nature of the establishment costs of the managers and on the timing difficulties experienced when required to complete the authorisation process;
- v. on the culture of the benchmark that has limited the creativity of managers and that has not motivated the entrepreneurial profile of the investment.

In relation to sub paragraph (ii), it is noted that very often the managers of speculative funds need a sophisticated financial infrastructure as well as easy access to financial intermediaries and companies. Moreover, in relation to sub paragraph (iv), it is noted that the management and structure of an Italian SGR is more complex than an analogous foreign structure, in that it involves the absorption of greater capital and a greater number of controls.

Figure 5: growth in number of Italian hedge funds



- How can the creation of those specific and innovative abilities considered necessary for the institution and management of the hedge funds be favoured? More generally, which initiatives would be necessary to adequately support such growth?

The opening of the Italian market to specialised and skilled foreign players is key to the development of its development. In this regard, the participants would like to see the elimination of the obstacles that prevent foreign managers from managing Italian governed speculative funds.

Some Companies also want a greater exchange between traditional and specialised managers, from an "osmosis" perspective.

Overall, the companies believe there are a number of key factors which will determine the future growth of the Italian market:

- the need for independent initiatives;
- the presence of "incubators" that support the start up of funds, through the development of a communal platform for operations and marketing, with the management entrusted to selected portfolio managers. Such a structure would permit potential managers of speculative funds to start actual activities without incurring the costs and experiencing the complexities of creating a new organisational structure;

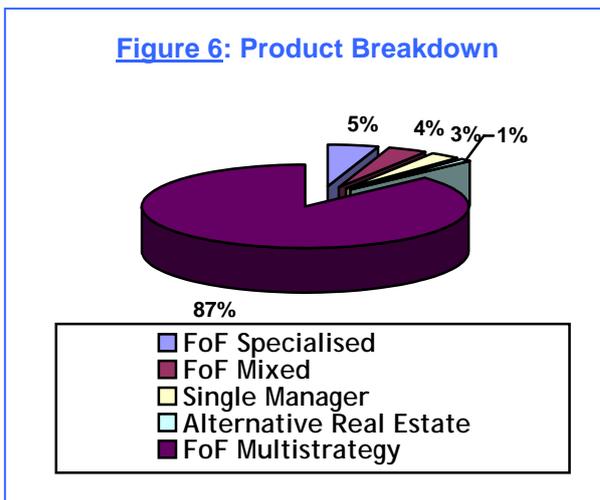
- the ability to exchange information/skills between traditional managers and speculative fund managers, also through the “admission” of foreign managers to Italy.
- investments into people and technology: the banking system should adopt a competitive rewarding criteria within its trading activity (thus forming motivated and risk-taking money managers) as well as invest in management development.

- Do you consider it appropriate to have a separate regulatory regime for single manager hedge funds and funds of hedge funds? If so, can you illustrate where specific regulation should differ (for example, diversification of the risks, leverage, unsecured sales, maximum number of participants, minimum threshold of investment, etc)?

The participants believe that there should be a separate regulatory regime for single manager funds and funds of hedge funds.

This differentiation should operate, above all, in terms of thresholds and investment limits. There should be a lower threshold for the funds of hedge funds.

It is generally accepted that a minimum level of investment in a single manager speculative fund should remain higher and that access to these funds should be confined to those investors that can prove a reasonable understanding of the product and its risks.



Relating to the minimum threshold of the investment, opinions are directed towards the adoption of an autorestriction mechanism by the managers of either single manager funds or funds of funds. They will be responsible for determining the appropriate capacity levels for their strategy/ies (instead of being limited by a minimum threshold) and determining when they close new investments into the fund.

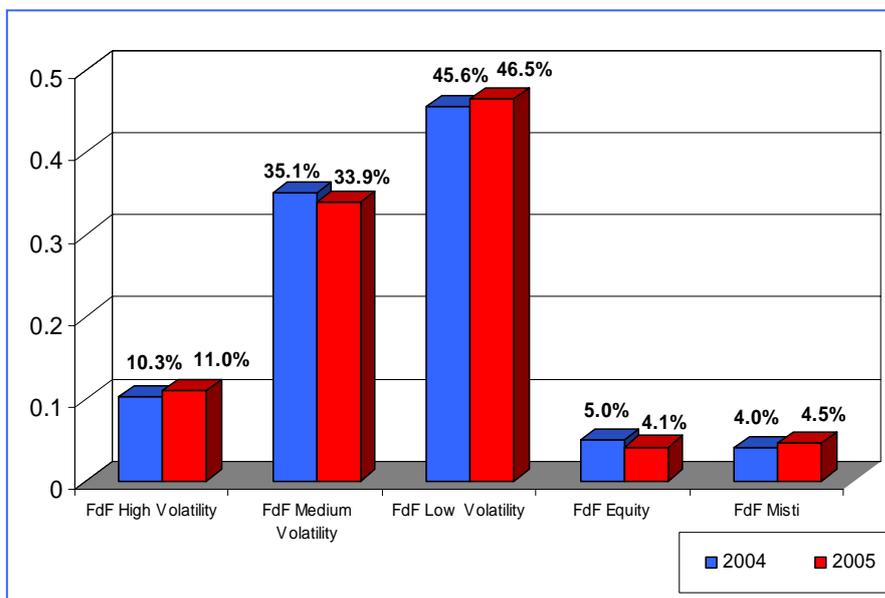
IV. Recently, the legislator and the Supervisory Authority have demonstrated that they are prepared to halve the minimum threshold for participation in speculative funds and to double the maximum number of participants. Yet, a number of participants want further legislative intervention in relation to this.

- *Do you agree with the limit of 200 investors currently provided for? If not, please set out your reasons (also in light of any further expenses sustained by the Company) and indicate the threshold that you consider necessary to balance investor protection and efficient management of the fund.*

The participants consider the limit on the number of participants of a speculative fund to be inadequate. Indeed, such a situation generates extra costs for the SGR and a negative scenario for investors (for example: a portfolio of €400mn is likely to have a greater choice of investment opportunities than one with only €100mn). Moreover, it is noted that the limit on investor numbers is not necessarily aligned with the investor interests and that *transparency* of the investment seems to over-ride *return* objectives.

With regard to such constraints, the market has responded with the creation of “clone” funds (which replicate those funds that have reached their investor limit (200 investors)) or “*master feeder*” structures. The latter create higher administrative costs for the management companies and for the investors: often the classes of new issues of clone funds are more expensive.

Figure 7: Funds of funds by strategy (2004/2005)



In light of their established experience within other markets, the respondents propose that the number of investors be decided by the managers.

- *Based on your experience, will the provision of a minimum amount of an initial subscription equal to €500,000 for all of the speculative funds satisfy the protection objectives of the investors provided for by the law in force? Please illustrate the different parameters or the different minimum thresholds of investments that you would consider suitable to apply to the selection of investors for single-manager or fund of hedge/multi-manager funds.*

The respondents agree that a minimum investment threshold is not necessary for investments into funds of funds. In fact, their view is that this provision would not offer sufficient protection to investors: a high investment threshold does not guarantee that the client is diversifying its investment (and is not investing all of its wealth into a single product).

In particular, some of the respondents' proposals suggest:

- that investment limits are removed on funds of funds and the provision of a limit equal to €50,000 is placed on the single funds;
- that the provision of a limit of €10,000 is placed on funds of funds; a threshold of €500,000 or €1,000,000 should be applied to single manager funds and the prohibition of splitting quotas should be removed thereby permitting access to retail investors under the control and competence of a qualified manager;
- a limit of €12,500 for the funds of funds and €50,000 for the single funds.

The respondents consider that the application of criteria for different investor profiles (that do not place restrictions on the funds) would be more appropriate than pre-fixed admission thresholds. As an example, the admission threshold could be compared to the net wealth of potential investors. Respondents quote USA legislation that provides for an admission threshold based on the net wealth of potential investors. Once the status of *high net worth individuals* has been verified, hedge funds can be accessed through the initial subscription of minimum amounts.

- *Can you explain the general procedure adopted by your company to comply with the splitting prohibition of the quotas (in particular in the case of investors that do not act on their own behalf)? Are you waiting for or hope for a review of the legislation in this regard?*

The respondents have proposed the following operative procedures:

- acquisition of self declarations from the subscriber relative to the number of investors it is acting for. In the event of a trustee subscriber, the trustee will be required to certify whether the subscription is made in its own name or the name of a third party. In the case of the latter, the number of people for which the subscription was carried out are considered as distinct, individual investors;
- specific declaration by the client of having acknowledged the splitting prohibition rule;
- careful monitoring (look-through checks).

With regard to possible reviews of the relative provisions, the general opinion of the respondents seems to be that the splitting prohibition should be eliminated.

V. As noted, Italian law is different to that of other European countries in relation to the regulation of the offer of quotas of speculative funds towards retail investors.

- *Do you consider that it would be appropriate to mitigate the solicitation prohibition in relation to the multi-manager funds or towards the investors (non institutional) the assets of which exceed a certain threshold?*

There is a view that the minimum investment threshold restricts the universe of potential investors; thus such solicitation prohibitions are penalising in terms of educating potential investors to understand hedge funds.

Alternatively, the solicitation prohibition could be measured on the characteristics of investors (as per the USA), focusing attention on the investor's specific status and eligibility at the time of subscription.

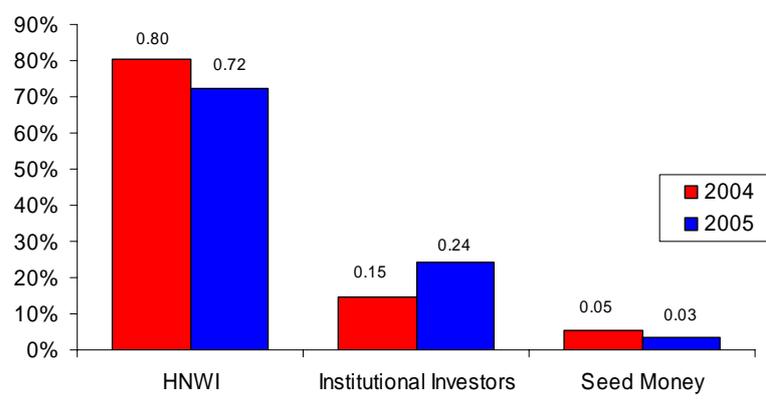
Further, respondents propose to “replace” the prohibition with a requirement to provide greater information on the risks of the speculative fund.

- *What are the main channels used by the company for research into its clients? Can you describe the main steps required to make an investment into your funds by such clients other than institutional investors?*

The procedures set out by the market participants of the sector make it clear that the channels most in use for the research of its clients are either via the private banking group’s structure or an internal sales network.

The private bankers act only upon specific written requests received from potential investors. Subject to production of the above mentioned request, they acquire materials from the SGR to be provided to the client.

Figure 8: Investor breakdown (as at 30 June 05)



Some participants hold one-to-one meetings, if the investors are not institutional investors; others meet exclusively with prospective clients being introduced by the Company’s shareholders and board directors.

During the preliminary phase of the investment, some companies will deliver to the prospective client explanatory brochures specifically created for this purpose.

- *What do you consider to be the main obstacles for the marketing of Italian speculative funds abroad?*

The main obstacles for the marketing of Italian speculative funds are:

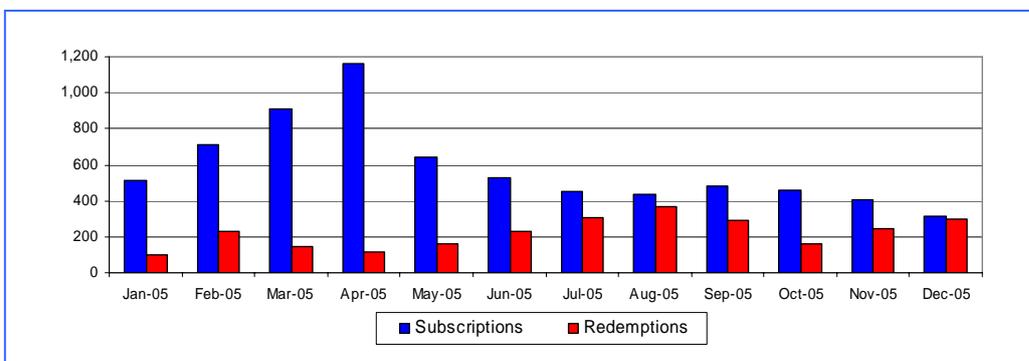
- the domestic taxation mechanism;
- Italy's lack of credibility;
- the rigidity of the legislation.

VI. In the early years of regulating, the Supervisory Authority excluded the possibility to indirectly invest into speculative funds through structured notes, social security and insurance products. This continues to be subject to lively discussions, particularly in consideration of the significant evolution of the domestic hedge funds market and of the ever more sophisticated and elaborate structures created (and marketed) by foreign "competitors".

- *What do you think of the alternative instruments that enable the investors to obtain exposure to the hedge funds? Could you please tell us about your experience in this area?*

With regard to structured product investments as an alternative to the direct subscription to speculative funds, some of the participants agree that such instruments provide an investment opportunity, useful for certain investors with particular needs. The characteristics of such products include: a principal guarantee, a possibility to invest in more alternative instruments, a possibility to employ leverage to increase the investment returns, the possible access to fiscal benefits.

Figure 9: Subscriptions and redemptions (€ million)



In order to reach an objective valuation of such products, it would be necessary to measure whether the value is in proportion to the costs.

Some participants consider that the “structuring” of such products could be helpful to carve out a more appropriate risk-yield profile for investors. Others consider, however, that the guaranteed principal structure does not adapt well to speculative funds. This is due to the lower risk profile that speculative funds (specifically the fund of funds) already employ.

Attention must be paid also to the level of additional product fees for such a guarantee - when fees are already high for speculative funds, thus impact returns.

It seems that no consistent reasons for prohibiting the distribution of such products exist. Even any potential methods of avoiding the restrictions to the splitting of speculative funds’ quotas in order to distributing funds to the retail clients could make sense. In fact, eventually such products will be totally different from any speculative funds given the fact that they employ a much lower amount of risk.

Moreover, with particular reference to insurance products that have underlying foreign hedge funds, the participants expressed a negative opinion noting that, often, these underlying funds are less regulated than Italian speculative funds. In particular, the main concerns surround “non European” target funds, where it is impossible rely upon a uniform regulation.

- *Could structured products (which satisfy absolute yield objectives and risk control with lower admission thresholds) provide the retail client with a better investment rather than the direct subscription of quotas to speculative funds?*

There is a great deal of difference of opinion in relation to the fact that the structured products could provide a valid alternative to the subscription of quotas to speculative funds.

Attention is directed to answers to the previous question.

It is also noted that while a structured product could be an appropriate non-traditional financial vehicle, it is burdened by costs. Additionally, the underlying speculative fund should have high liquid characteristics.

In terms of perception, certainly, prospective investors seem to consider that such products are less of a risk.

- *How should such products be structured and to whom should they be offered to preserve the interests of the clientele and the market need for efficiency and safety? What weight should be given to the hedge funds within such products?*

The structure of the alternative CPPI products (*"Constant Proportion Portfolio Insurance"*), or *zero coupon* with options, is more preferable to participants. These products deal with construction financing that guarantees principal protection.

Nevertheless some of the respondents have indicated that the kind of structure for such products depends on the risk-return objectives. Therefore, the specific structure should meet the range of client needs and should not be assumed beforehand.

- *In your opinion, how should the relative legislation be amended?*

Some of the participants have expressed the need to amend the provisions on the structured products so as to permit the "construction" of structured products indexed to speculative Italian funds and which can be subscribed to by retail clients.

The need to strengthen the transparency obligations in regard to the risks and costs has been recognised, enabling the client or his advisor to evaluate the additional value of the product.

A further requirement that was strongly voiced was the need to avoid "legal arbitrage". This means removing the prohibition of distributing structured products; today, such products can be sold from a number of foreign markets thus creating a competitive disadvantage to Italian managers.

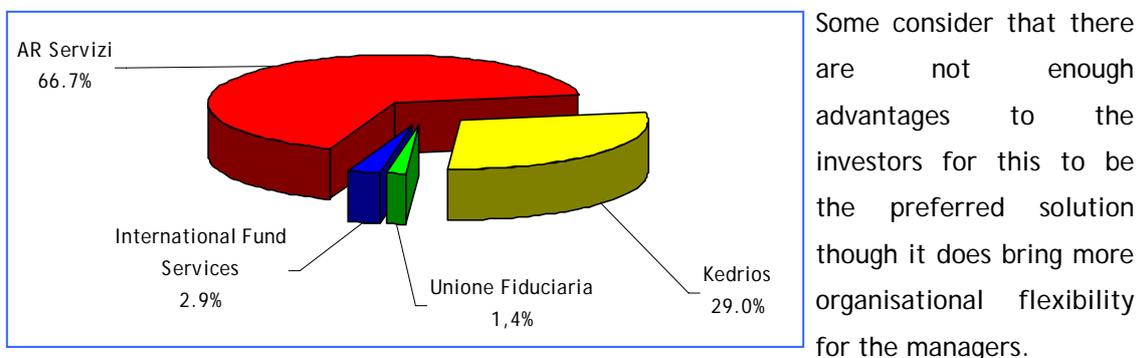
VII. The relationship between SGR and other entities involved in the management of speculative funds remains a delicate part of the regulation - with there being a strong need to leave ample space to manager autonomy.

- *In your opinion, what are the main advantages and disadvantages for investors entrusting the custodian bank with the task of calculating the NAV? Please briefly tell us about the process adopted by your company in relation to such calculations.*

Entrusting the NAV calculation to the custodian bank is considered to be the best solution by the majority of speculative fund market participants, even if these participants adopt different solutions.

The main advantage of entrusting such tasks to the custodian bank is the existence of an independent third party ("terzietà") required to carry out the calculation. In compliance with international market practice, such a mechanism would guarantee greater transparency and fewer conflicts of interest as security for investors.

Figure 10: Back office service companies



The negative aspects to this arrangement are:

- the banks' lack of competence, with possible consequences in regard to the quality of pricing and the timeliness of calculations;
- increase in costs.

The participants have described different solutions adopted in order to calculate the Net Asset Value (NAV):

- the calculation of the NAV is carried out in accordance with an internal dealer's structure and is subject to subsequent checks by the custodian bank;
- the calculation is entrusted to the administrator that processes the data received from the SGR;
- the NAV is calculated on a monthly basis by the managers' accounting department;
- the calculation of the NAV is outsourced;
- the calculation of the NAV is outsourced though subject to checks by the manager's administrative personnel or back office;
- the NAV [of the fund of funds] is calculated on the basis of the total NAVs of the target funds in which it is invested: the target funds' NAVs are transmitted by each fund's administrator to the fund of fund's administrator, to the fund of funds manager and to the custodian bank at the same time

Some feel that outsourcing the calculation of the NAV could bring a slight increase in the cost structure of the fund; such increase could be avoided only through a reduction of the management fees.

- Do you consider that the introduction of uniform valuation criteria could be advantageous for the investors, encouraging greater competition between the speculative funds and reducing the risk of valuation errors of the quotas?

With regard to the consistency of valuation criteria to be adopted for the calculation of the NAV, the main requirement seems to be to clarify those rules that exist today - particularly regarding the provisional NAV and the admitted percentage errors. Participants complain that there is no uniform procedure. (No further examples were given in relation to this).

In particular, participants point out that uniformity in evaluations could have a positive effect on investors.

- In your opinion, what will the advantages be for investors where there is an incentive for them to turn to foreignservice providers with regard to the administrative services (including for example back office and middle office services)?

In regard to fund administration, the possibility of taking advantage of the services of foreign service providers seems to be a desirable approach. All note that, if this occurs, this could result in improved knowledge and abilities for the Italian marketplace and its participants.

Even the higher potential costs in outsourcing to foreign service providers could be compensated for by an increase in the quality of the service.

In any event, the costs could pose a problem in the short term, whereas in the medium/long term period there will be an increase in the competitiveness thus a possible cost reduction.

- Please tell us how the Company makes use of the management delegation to foreign intermediaries. Please specify also the place where such intermediaries have their offices as well as the existence of any inter group relationships.

The delegation of management to foreign intermediaries seems to be non-existent in the Italian speculative funds' marketplace. Such delegation exclusively involves specific management aspects of selecting hedge funds for funds of funds).

Participants highlight that a model which tends not to outsource any management responsibilities guarantees the full control of the investment process.

VIII. We would like to ask you to verify any further update requirements in the law in force.

- Are any further legislative interventions required that are deemed necessary or appropriate in relation to: (i) prevention and management of conflicts of interest, (ii) relationships with the prime broker, (iii) allocation of the charges and expenses between the SGR, the fund and the subscribers, (iv) asset adequacy, or (v) with reference to any other aspect of the regulations?

The opinions on the most crucial aspects of the Italian legislation on speculative funds have already been set out in this document.

The respondents mainly require a review of the provisions of the minimum level of assets required (capitalisation level, reserve assets). They assume that, relative to other markets, this is a negative factor in the growing of the Italian marketplace.

Additionally, the information level in the accounting statements is quite rigid and there does not seem to be any possibility of simplification with regard to speculative funds.

It is evident that a lower information level would have an effect on transparency and, therefore, on the investors, but it would raise competitive levels.

- Is it considered that a higher market transparency level could contribute to greater performance?

The market transparency level is not considered by the participants as a performance guarantee.

Performance is not related to transparency but to the ability of the managers to select the best funds and, more generally, to make use of their contractual strength.

- *Do you consider that improvement in competitiveness of the national fiscal regime is necessary with respect to those in force in other European countries?*

All of the speculative management companies consider that there is an absolute need to improve the fiscal regime.

In particular, the participants look forward a change being made not just to the amount itself (12.5%) but also to the mechanism applied.

They state that the taxation mechanism should be compared with those of foreign hedge funds, with a consistent change from the actual taxation "*nettista*" (tax is automatically deducted on regular calculation of returns) to a new "*lordista*" taxation (at which tax is deducted only at the moment of the exit from the fund).

- *Is it favourable to maintain the actual denomination "speculative funds" ("fondi speculativi")? What alternative name would better represent these kinds of funds to investors?*

The participants consider that a change of the actual name "speculative funds" ("*fondi speculativi*") is absolutely necessary.

The name is considered misleading in that it misrepresents the product as strongly aggressive, which is not a characteristic held by speculative funds governed by Italian law - particularly for funds of funds.

Therefore, either of the following are preferable: (i) the inclusion of "hedge" adopted on an international level, which gives a concept diametrically opposed to that of "speculation"; or (ii) the inclusion of "alternative funds" that exclusively reflect the "non traditional" nature of the investment.

Work plan: possible interventions

Strategy	Provisions	Structure and Resources
❖ Allow the exchange of knowledge between traditional managers and specialised managers even through opening up to foreign market.	❖ Decreasing the entry thresholds into speculative funds and reducing the rigidity of the distribution system, through the creation of self-restriction mechanisms by the manager.	❖ Adopt efficient organisational methods that guarantee the “effective” separation between the administrative and management functions also through the adoption of specific separation protection procedures.
❖ To increase sector specialisation of the speculative funds.	❖ Abolish the prohibition on the splitting of quotas.	❖ Promote the development of the market knowledge and ability of its participants.
❖ Improve the perception of the speculative products in the market intensifying the “ <i>hedging</i> ” characteristics.	❖ Clearly distinguish the regulation of speculative funds from that of funds of funds.	❖ Expand the <i>info</i> -formation channels.
❖ Improve the competitiveness of the Italian market.	❖ Change the name “speculative funds” (“fondi speculativi”).	
	❖ Permit the structuring of products indexed as domestic speculative funds available to retail clientele.	
	❖ Change the fiscal mechanisms which are in place today	

SOURCES

- Figure 1: **Italian hedge fund industry asset growth (€billion)**
MondoHedge (data referred to AUM as at Jan 2006)
- Figure 2: **Italian assets and wealth management**
Assogestioni (as at 31 Dec 2005)
- Figure 3: **The Italian market (asset management companies)**
MondoHedge (as at Jan 2006)
- Figure 4: **The Italian market**
MondoHedge (as at Jan 2006)
- Figure 5: **Growth of number of Italian hedge funds**
MondoHedge (as at Dec 2005)
NB: in December 05, there were 137 funds of funds, 12 mixed funds of funds, 10 single managers and two alternative real estate funds - who had issued at least one monthly performance figure
- Figure 6: **Product Breakdown**
MondoHedge (as at Dec 2005)
Percentages based on €16.5billion (assets managed by Italian hedge funds)
FoF Specialised: multimanager FoF but with a focus on a specific strategy (eg, equity long short FoF)
FoF Mixed: portfolios of hedge funds, long-only funds and other assets (equity, government bonds, etc.)
FoF Single Manager: single manager hedge funds
- Figure 7: **Funds of funds by strategy (2004/2005)**
MondoHedge (as at Dec 2005)
- Figure 8: **Investor breakdown (as at 30 June 2005)**
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- Figure 10: **Back office service companies**
MondoHedge (as at June 2005)

About AIMA

Founded in 1990, AIMA is a not-for-profit global trade association with corporate membership in 46 countries. AIMA focuses specifically on hedge funds, managed futures and managed currency funds. Over 1000 corporate members (comprising 3500+ individuals) fund the Association, enabling it to create global tools for the benefit of its members, institutional investors and regulators. Its objectives are to increase investor education, transparency and promote due diligence and related sound practices, and to work closely with regulators and interested parties in order to promote the responsible use of alternative investments. AIMA's membership includes fund of funds managers, institutional investors, hedge fund managers, prime brokers, exchanges, fund administrators, auditors, lawyers and other specialist service providers.

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Simmons & Simmons has been operating in Italy since 1993. With offices in Milan, Padua and Rome, 20 partners and over 100 legal staff, we have firmly established ourselves as one of Italy's leading law practices.

The firm's market-leading hedge funds practice has been providing authoritative advice to hedge fund sponsors and managers since the development of this dynamic industry in Europe over a decade ago. Reflecting the practice's market leading position, the legal directory Chambers 2005 describes the firm's specialist hedge funds practice as "undoubtedly superb".

In Italy, Simmons & Simmons works with many of the leading players in hedge funds and we are at the forefront of the market's evolution. Our strong domestic and international profile has enabled us to play an active role in the ongoing development of the country's regulatory regime.

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