



Speculative funds

Speculative funds, better known outside the Italian market as hedge funds, can be defined as funds that are not subject to predetermined investment limitations or to the prudential rules of the Bank of Italy on limitation and the spreading of risks.

This briefing outlines the principal features and regulations of speculative funds that have recently been the object of the government anti-crisis measures limiting any increase in requests for early redemptions of units.

Features and regulation of speculative funds

Speculative funds, better known outside the Italian market as hedge funds, can be defined as funds that are not subject to predetermined investment limitations or to the prudential rules of the Bank of Italy on limitation and the spreading of risks. In particular, speculative funds may invest in assets other than those provided by the relevant Italian provisions for other investment funds. These are:

- listed and non-listed financial instruments;
- cash bank deposits;
- real property and rights to real property;
- credits and securities representing credits; or
- assets other than financial instruments and bank deposits, for which there is a market and which can be valued at least on a half-yearly basis.

Like other investment funds, speculative funds consist of a segregated pool of assets without a corporate nature and are divided into units that belong to a number of participants and are managed by an asset management company (*società di gestione del risparmio*; SGR). Speculative funds may create their assets through one or more issues of units under article 1, paragraph 1(j) of the Legislative Decree No. 58 of 24 February 1998, as further supplemented and amended (the Consolidated Finance Act).

As for the classification of speculative funds, they are not undertakings for collective investments in transferable securities funds because they are not subject to the

EU directives on investment funds. They are regulated exclusively by contractual provisions and are not subject to the general rules provided by the Bank of Italy for open or close-ended funds and, therefore, they are seen as unrelated to the two models.

Speculative funds have recently been the object of the government anti-crisis measures contained in the Law Decree No. 185 of 29 November 2008, converted into the Law No. 2 of 28 January 2009 (Decree 185) and implementing Bank of Italy regulations of 16 December 2008 (December 2008 Bank of Italy Regulations) with the aim of limiting any increase in requests for early redemptions of units due to the current situation in the financial markets. The details of the new rules are specified in this briefing.

The principal features of speculative funds are the following:

- they may invest in any kinds of assets without being subject to the prudential rules on limitation and the spreading of risks;
- the minimum subscription amount must not be less than €500,000;
- speculative funds must not be offered to the public; and
- the fund regulations of speculative funds (*regolamento del fondo*) must make express mention of the risks related to investments in the fund and of the fact that it is made by derogation from the prudential rules of the Bank of Italy on limitation and the spreading of risks.

Speculative funds are regulated by article 16 of the Ministry Decree No. 228 of 24 May 1999, as amended by the Ministry Decree No. 256 of 14 October 2005 and the Ministry Decree No. 47 of 31 January 2003 (Decree 228) that implement article 37, paragraph 1 of the Consolidated Finance Act. Other legislations regulating speculative funds are:

- the Bank of Italy regulations of 14 April 2005, as recently amended by the Bank of Italy Order of 16 December 2008 that provides the implementing rules of the EU Directive 2007/16/EC on eligible assets (April 2005 Bank of Italy Regulations), containing the general rules on SGRs and their management, including authorisation procedures, investment limits, evaluation criteria of the fund assets and the activity of independent experts;
- the Bank of Italy Order of 21 June 2007, amending April 2005 Bank of Italy Regulations, about the objectives of SGRs and fund regulations;
- the Bank of Italy and the Consob (*Commissione Nazionale per le Società e la Borsa*) joint regulations of 29 October 2007 providing the MiFID Directive 2004/39/EC implementing rules; and
- the Decree 185 and the implementing December 2008 Bank of Italy Regulations.

Establishment of speculative funds

Speculative funds are established by a resolution of the SGR, which also approves the fund regulations of the fund.

The SGR no longer has to be a specialised speculative SGR and any SGR can establish a speculative fund under June 2007 Bank of Italy Order, which repealed this requisite.

To set up a speculative fund, the SGR must approve the fund regulations that are the basis of the investment fund system on its contractual relationships with unit holders and of corporate governance. The April 2005 Bank of Italy Regulations provide that the fund regulations of speculative funds must contain at least the following information:

- the name and duration of the speculative fund;
- the name of the SGR promoter as well as the SGR manager if different from the promoter (it is possible to separate the promotion and establishment of the fund from its management. This entails a fund being

promoted and created by one SGR and managed by another. In this case, both SGRs are jointly liable vis-à-vis with the funds' unit holders);

- the name of the depositary bank;
- the division of tasks between the SGR and the depositary bank and the rules governing the relationships between them and the unit holders;
- the purpose of the fund and the investment policies;
- the relevant bodies and any third parties appointed by the SGR to choose investments;
- the criteria for the determination of the proceeds and performances for managing the fund, as well the methods for the distribution of such proceeds;
- the expenses to be paid by the participants, by the fund or by the SGR;
- the deadlines and procedures for the subscription and redemption of units;
- the procedure for amending the fund regulations;
- the liquidation procedure for the fund;
- the modalities of publication of the value of units;
- the modalities of publication of accounting documents;
- the duty to make available the management regulations at the time of subscription;
- the risks related to investments in speculative funds specifying that it is made by derogation from the prudential rules of the Bank of Italy on limitation and spreading of risks;
- name of the fund indicating its nature (ie speculative fund);
- if speculative funds of hedge funds operating abroad, the specific risks connected with such investments;
- amount of subscription;
- the terms and conditions to be applied if the fund procures the services of prime brokerage and external advisors, if any; and
- the maximum level of indebtedness of the fund and the financial leverage limits that the fund would like to obtain.

The time limit for the approval of the fund regulations by the Bank of Italy is three months from the submission (article 39, paragraph 3-*bis* of the Consolidated Finance Act), subject to suspension and interruption.

New anti-crisis rules for speculative funds

The Italian government has recently approved new rules for speculative funds to protect speculative funds from the current economic turmoil characterised by a significant lack of liquidity of the financial markets.

The new rules, which are contained in article 14, paragraphs 6, 7, 8 and 9 of the Decree 185 as implemented by December 2008 Bank of Italy Regulations, provide that, up to 31 December 2009, the fund regulations of speculative funds may be amended to insert the following provisions.

- a) If the requests for early redemption of units in a certain period of time exceed a total of 15 per cent (so-called 'gate') of the net value of the fund, the SGR is entitled to suspend the redemption of units exceeding such percentage in a proportional manner for each participant that has requested the redemption of units. The unredeemed units are considered to be a new redemption request submitted on the first day following the execution of the partial redemption.
- b) In the exceptional case where the transfer of illiquid assets of the fund, required to cover the requests for the early redemption of units, may jeopardise the interests of the participants, the SGR may resolve a partial split of the speculative fund, with the assignment of the illiquid assets to another *ad hoc* closed-end fund (so-called 'side-pocket'). Such closed-end fund is aimed at liquidating the assigned assets under the plan approved by the SGR. Every participant gets the same number of units of the closed-end fund as the number it held in the speculative fund. The closed-end fund may not issue new units; the units of the closed-end fund are redeemed as soon as the activities are liquidated.

According to the Decree 185, the amendments to the fund regulations of speculative funds intended to insert the provisions indicated above under a) and b) will take effect on the day on which they are approved by the Bank of Italy and are also applicable to the requests for redemption that have been previously submitted to the SGR.

In addition, the Decree 185 has annulled the limit on the maximum number of participants in a speculative fund (ie 200) that the Decree 228 had provided to prevent funds from registering an overgrowth.

Speculative funds in the Italian financial market

Speculative funds in the Italian financial market have developed rapidly since their introduction by the Decree 228. According to a report published on July 2008 by a working group coordinated by the Bank of Italy with the participation, *inter alia*, of MEF (*Ministero dell'Economia e delle Finanze*) and Consob, 'over the last ten years, Italian speculative funds have proved to be a useful instrument for diversifying investment portfolios'.

The most common type of speculative fund in Italy is the fund of hedge funds (FoHF), also called the 'fund of second level', which invests its assets in units of different hedge funds called 'funds of first level', mainly operating in the US and off-shore markets. It is worth noting that, according to April 2005 Bank of Italy Regulations (title V, chapter III, section VI), FoHF is admitted only if the fund of first level invests directly in financial instruments other than investment funds.

The development of FoHF in Italy can be explained by the fact that it ensures that the subscribers have a wider technical spreading of the risk than funds of first level. In fact, on the one hand, the funds in which FoHF invest are identified and monitored by means of due diligence and risk management procedures; on the other hand, the diversification of the funds contained in the investment portfolio leads to a reduction of the negative impact on the assets of FoHF caused by any losses of the single funds.

Although FoHF is the predominant operating scheme, there are also normal 'single manager' (*gestore unico*) speculative funds in Italy.

The Bank of Italy Report states that now that it is ten years since rules on speculative funds were introduced, they should be revised to allow further development and competition in international markets. To this end, the Bank of Italy Report declares that it would have been appropriate:

- i to reduce the current restriction on the minimum subscription amount for the investment; and
- ii to diversify the regulation between the FoHF and the funds with a single manager to allow the former to be distributed to the public.

