Alternative investments in Finland*
Survey 2006

*connectedthinking

PricewaterhouseCoopers

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1 Foreword

This survey provides an overview of some of the recent issues and developments in alternative investments in Finland and draws on some of the issues and trends surrounding compliance and risk management around alternative investments.

Alternative investments have experienced considerable steady growth in recent years, in terms of the number of funds, the investments and the assets under management. The search for higher returns and diversification has sparked a huge surge in alternative investments. Institutional investors and portfolio managers are searching for ways they can maximise returns and diversify allocations by using alternative investments. The benefits of alternative investments, which covers at least hedge funds, hedge fund of funds, private equity (hereafter PE), venture capital funds (hereafter VC) and real estate funds, include potentially higher returns, reduced volatility, diversification benefits resulting from lower correlation with other investments, and in some cases more liquidity than some other direct investments in real estate or ventures.

Introducing alternative investments has become a priority for many institutional investors and investment managers, which often requires a change in skill-set and mindset. Alternative investments are also bringing up new critically important issues. Institutionalisation of the alternative investment industry is imposing new responsibilities and challenges upon managers and advisors. Strict risk controls and relative performance and risk exposure analyses are now basic demands of investors. To remain competitive, investment managers need to implement the latest techniques to outperform, and advisors and fund managers must also increasingly counsel investors on how to incorporate alternative investments optimally into their existing portfolios.

2 Background to the survey

The background to this survey has been the ever-growing interest towards alternative investments globally and increasingly so in Finland. In this survey, we have tried to bring together the views of investors, fund managers and service providers to the industry with regard to critically important issues, and trends and developments surrounding alternative investments. An alternative investment questionnaire was created to collect information from different survey participants together with interviews with investors, fund managers and other market participants. The survey was developed with the objective of better understanding some of the questions associated with key issues, trends and developments surrounding alternative investments. The survey participants included over 30 key investors and asset managers, as well as several other specialists. All participants have significant assets under management and they include many of the key Finnish investors and asset managers.

The total amount of assets under management of investment funds registered in Finland was approximately 50.8 billion euros in February 2006. In addition, there were also investments in funds that are not registered in Finland. Volume has increased significantly since the end of 2004, when the amount of assets under management totalled 31.1 billion euros. In the beginning of 2006 around 3.2 % of total assets under management were invested in special common funds such as hedge funds. In February 2006 a total amount of 1.6 billion euros was invested in hedge funds in Finland, compared with 1 billion euros at the end of 2004.

A total of 311 million euros of private equity investments were made in Finland in 2005, and a total of 416 investments in 242 different companies were made in the same year[1]. Initial investments accounted for the majority of the amounts invested, whereas follow-on investments accounted for the majority of the number of investments. Large buyout investments dominate distributions of the amounts invested. Fundraising was at 629 million euros, which was 100 % higher than in 2004. Total assets under management in 2005 stood at 3.07 billion euros.

The transaction volume in real estate investments in Finland was 2.7 billion euros in 2005. The foreign investment share of the total investment volume was about 40 %. Already over 30 international real estate investors have established themselves in Finland. In 2004 the transaction volume was 3.2 billion euros, and the share of foreign investments amounted to 46 %. The combined market value of the five property companies listed on the Helsinki Stock Exchange at the end of 2005 was 1.3 billion euros, representing less than 0.6 % of the market capitalisation of the Stock Exchange. The combined market value of the property portfolios of these companies stood at approximately 2.6 billion euros.

Alternative investments are sometimes still viewed by some as high-risk investments partly due to lack of available information on the investments and also due to some secrecy surrounding the investment strategies and risk profiles. Alternative investment is a term typically used by investors to describe investments other than stocks and bonds. Strategies commonly classified as alternative investments include private equity, leveraged buyout (LBO) funds, arbitrage strategies, hedged strategies and “event-driven” strategies. Some people also classify real estate and VC as alternative investments. Institutional investors often consider alternative investments as less

[1] *Finnish Venture Capital Association (FVCA)*

risky than direct venture instruments, commercial real estate, distressed securities and junk bonds. Even though many institutional investors allocate a small, single-digit percentage of their assets into this class, some funds have achieved more favourable returns than larger allocations of other types of investments. The drawbacks include potential one-time losses from rare events and potentially high management fees. The main asset category among alternative investments has typically been hedge funds.

Assets in hedge funds overall continue to grow, with sales of asset management businesses worldwide surging significantly in 2005. The demand for alternative investments has also stimulated strong interest in the creation of new instruments. In many cases, investment strategies were changed towards hedge-fund-like strategies. The hedge fund industry in particular has experienced considerable growth in recent years, in terms of both the number of funds incorporated/developed and the assets under management. Investments from institutional investors have increased considerably across the globe over the last few years and the trend seems to be continuing.

Hedge funds are anything but a uniform asset class. They are surrounded by vague strategies and mystique, which is why they are often viewed as a high risk and speculative investment. A lot has been done already over the last few years to shed more light on hedge funds, but there is still lot to do to improve, for instance, the performance and risk reporting, and communication of the strategy. The legal framework of hedge funds varies significantly from country to country, as does the terminology used. The term hedge fund is not yet defined in Finnish legislation. In Finland special common funds, regulated by the Finnish Financial Supervision Authority, FIN-FSA, are often called “hedge funds”, even though they are often very different from most of the hedge funds managed abroad, for example in Great Britain or the USA. In Finland mutual funds can be broadly divided into two categories: UCITS funds[2] and non-UCITS funds, which also include special common funds.

There is increasing concern in the alternative investment industry, driven by the demand from investors, to ensure that the interests of investors are protected, and that the industry continues to improve its practices, i.e. self-regulation. Some of the key developments and challenges facing the industry relate to pricing, valuation issues, reporting, technology and investment strategies. The deployment of technology that can trade exotic products, measure risk, value the portfolio and settle the instruments is becoming increasingly important. It has always been of paramount importance that investors fully understand the asset management strategy that the manager complies with and that they are aware of the key risks involved. The alternative investments industry will most probably continue to grow over the coming years, but to do so it must also develop its practices to serve investors better, especially whenever more non-professional investors are increasingly starting to look for alternative investments.

We would like to thank all those who participated in this survey for their valuable contributions. We will continue to monitor the alternative investment market and we would encourage any feedback and/or suggestions to improve our forthcoming surveys.

[2] UCITS stands for Undertakings for the Collective Investment of Transferable Securities.
These funds can be marketed within all countries that are a part of the European Union, provided that the fund and fund managers are registered within the domestic country. The regulation recognises that individual countries within the European Union may differ in their specific disclosure requirements.

3 Survey message and executive summary

Domestic institutional investors have already been involved with alternative investments for some time. When asked about their relative allocation in this asset class, most mentioned that within the next few years the proportion of total assets under management would rise. Over half of all participants stated that PE, VC and real estate funds weighting would increase. Real estate funds are growing despite the relatively short history of real estate investments here in Finland, where 95 % of participants currently have less than 10 % of their total investments in this category.

Transparency in strategy and investments, the reputation of the team, quantitative skills and past performance were key factors in the decision-making process when selecting an alternative investment counterparty. Price played a less important role. Historical performance, appetite for absolute return, a more diversified portfolio and better risk-adjusted return were the main reasons for allocation shifts from conventional money market and equity funds into hedge funds. Low correlation and volatility were also mentioned.

In PE and VC funds the most commonly supported arguments for adding relative weight were high expected return, diversification benefits, low correlation and transparency, whereas poor liquidity and price fluctuations were seen as less important.

In real estate investments the inflation shield was most commonly cited as an advantage. Overheated real estate markets, bad liquidity, high costs and a lack of transparency reflect negatively on real estate investments.

One key finding was the origin of the estimated growth. According to fund providers, 56 % of the estimated growth originated from new customers, whereas the global PwC Wealth Management survey in 2005 concluded that the vast majority of the future growth was expected to come from existing customers. Volume growth in hedge funds in the next two years has been estimated to reach 60 %, and in PE to be close to 80 %.

Domestic hedge funds, PE and VC, and real estate funds were anticipated to be less competitive compared with international counterparties due to the small local markets, and the legal and tax benefits favourable to foreigners. In hedge funds quantitative methods, access to information and resources were also key elements.

Transparency in various forms was highlighted several times among institutional investors. More information about risk management, vacancy rates of real estates in real estate funds, enumeration of employees, strategy, and valuation and the general business environment were requested.

When asked about challenges in offering different products, PE companies replied that the track record of managers and the historical earnings were more important than the investment rules and the risk management processes.

The major internal challenges investors face include the hiring of skilful personnel with an attractive salary component, the adaptability to change and the low risk profile combined with a constant profit pressure. PE companies mentioned different legal agreements for each investment case, whereas hedge funds pointed out that valuation and administration problems of newly implemented instruments and growth management were key challenges.

External advisors were widely used in business development projects in separate related areas among PE firms and investors. PE companies prefer legal and tax advisors in business development decisions, but audit services and environmental advisors were also used. IT, software and technology advisors were not used that frequently in hedge funds. In new investment projects, all PE companies used advisors in separate related areas - 50 % among investors and about 30 % among hedge funds. An unusual discovery was the fact that only a few companies used consultants in ERM (Enterprise Risk Management), as the demand in the market for improved risk management transparency is continuously increasing.

When asked about the reasons for increased competition, hedge funds raised some concerns including customer service, customer restrictions on risk or asset allocation, clients' low awareness of hedge fund products, authority regulation and fund credibility. PE companies today are facing severe competition and it looks set to continue even though some mergers are expected to happen.

In a comparison between local and global issues, it was found from the survey responses that domestic players, especially hedge funds, are in an unfavourable position when it comes to leverage usage. Unfavourable tax issues may also limit investment in Finland by foreign alternative investment funds.

GIPS (Global Investment Performance Standards) were widely accepted. The size of the investment organisation also determined the extent that external services were used. It is also worth mentioning that fair value determination for non-listed companies was a big challenge. About 60 % of investors and hedge funds have a systematic valuation process, although judgemental valuation was still used by a large number of investors.

ERM has gained popularity companywide. Basel II requirements have put more pressure on operational risk management issues. Obviously, it seems that players in the Finnish alternative investments market are starting to appreciate a wider view of risks than just the risks related to conventional investments and financial markets. Over 80 % of investors and PE companies and around 65 % of hedge funds claim to have FRM (Financial Risk Management) processes and functions implemented.

Finally, quite an interesting finding was that high ethical standards were an insignificant factor in the investment process and it was not deemed likely to play an integral part of the investment decision process in the coming years. Also only one-third of interviewed investors felt that fund managers have high ethical standards.

To conclude, alternative investment instruments are becoming ever more common, as risk appetite has undoubtedly increased among investors due to the favourable market conditions and as there is more idle money for reallocation. Professional institutional investors already have the knowledge of market behaviour, and some smaller market participants such as foundations are also increasingly looking for additional returns in the field of alternative investments. Investor sophistication has also increased over the last few years, which has enhanced the growth of the alternative investment industry.

4 Market trends in the alternative investment sector

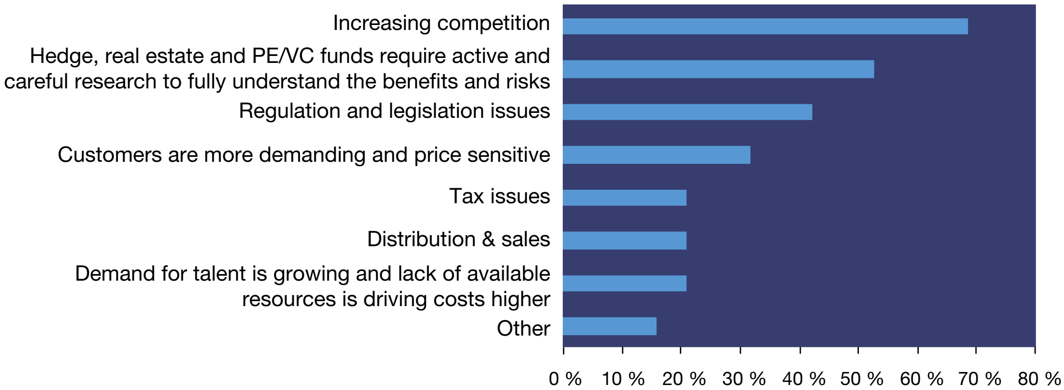
Although the market for alternative investments for investors and providers has been growing intensively both internationally and on new markets, there seems to be little sign of a slowdown. Hedge funds, as well as PE, VC and real estate funds, have been the investment instrument of choice for participants in the investment community ever since they started to gain public attention.

Earlier studies have shown that despite all the interest they attract, providers of alternative investments do not achieve success without facing challenges. Globally, fund managers are preoccupied with issues like the rapid growth of assets, ever-increasing regulatory scrutiny, and greater demands from investors[3]. In the Finnish market[4] the main concerns have been financial issues, in particular the return on capital, earnings and revenue growth, and expense control or reduction.

Business Issues – Investors

In this survey the results indicate that increasing competition is viewed as the most critical business issue investors face today. Another key business issue investors recognise is that hedge, real estate and PE and VC funds all require active and careful research for investors to fully understand the benefits and risks of those funds. On the other hand, tax issues were not viewed as being that important. Regulatory and legislative issues are also seen among the more common challenges investors have to encounter.

General business issues facing investors today



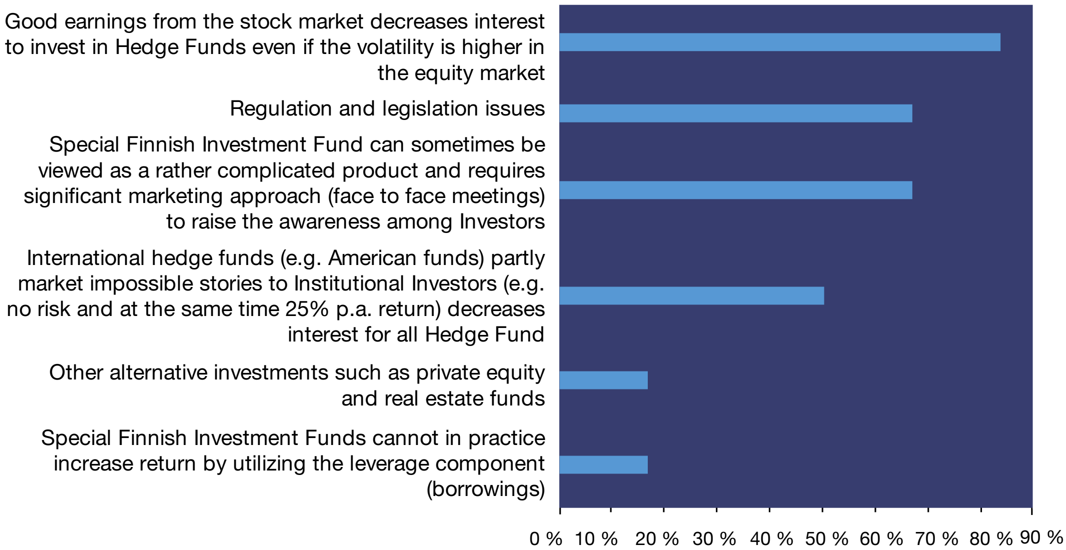
Business Issues – Hedge Funds

For hedge funds, the most common business issue appears to be attracting more clients. Recently, good earnings from the stock market have seen a slowdown in the growth of alternative investments despite higher volatility in the equity market. Another

[3] *PricewaterhouseCoopers 2004: Global Hedge Fund – Valuation and Risk Management survey.*
[4] *PricewaterhouseCoopers 2004: ERM benchmarking survey.*

issue limiting the growth of alternative investments, and especially investments in Finnish investment funds, has been the opinion that the products are sometimes a bit too complicated, which then requires significant marketing (i.e. face-to-face meetings) to raise awareness among investors. The marketing of international hedge funds to Finnish investors has sometimes included unrealistic promises to investors, such as a return of 25 % p.a. and low volatility. These types of false promises have had a negative impact on the selection of hedge funds as an investment instrument, and have made it (in some instances) more difficult for Finnish hedge funds to attract Finnish investors. Overall regulation and legislation issues have also been an important challenge for hedge funds.

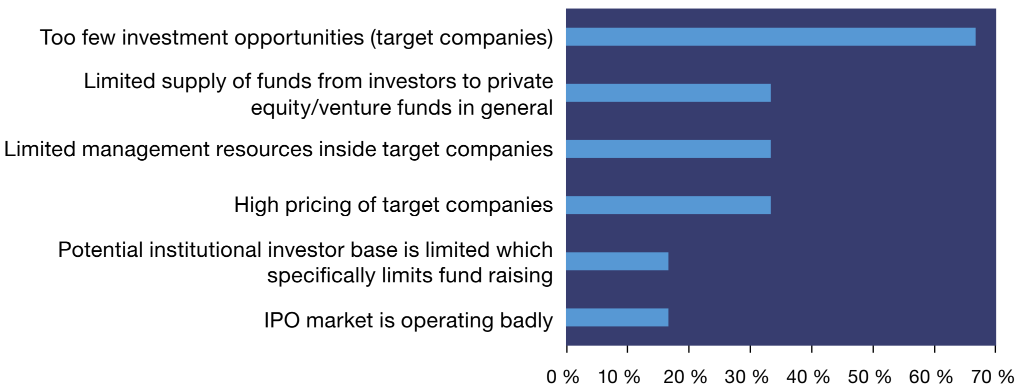
General business issues facing hedge funds today



Business Issues – Private Equity

A lack of good investment opportunities (i.e. in target companies) together with a limited flow of funds from investors is viewed as the key issue driving the target prices higher.

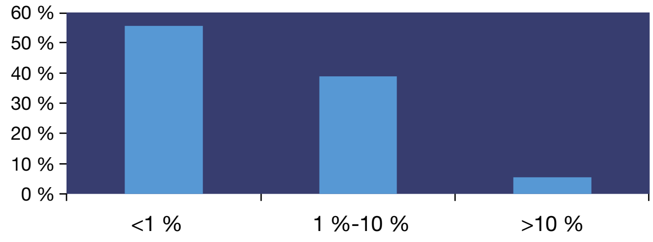
General business issues facing private equity companies today



Investing in alternative investments

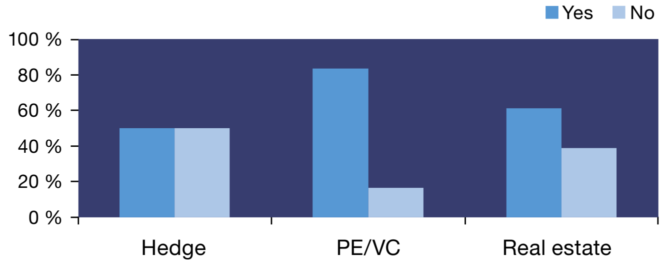
Alternative investments have seen growing interest internationally, and in Finland interviewed investors currently have less than one percent of their portfolios invested in hedge funds. The results indicate that a major change in investment attitudes is about to begin, because half of the interviewed investors claimed that they are proposing to increase their hedge fund investments over the next three years.

The proportion of hedge fund investments of total investments



Based on the responses, we believe that up to 83 % of the investors are proposing to increase their PE and VC investments over the next three years.

Are you likely to increase your hedge fund, PE/VC or real estate fund investments in the next 3 years

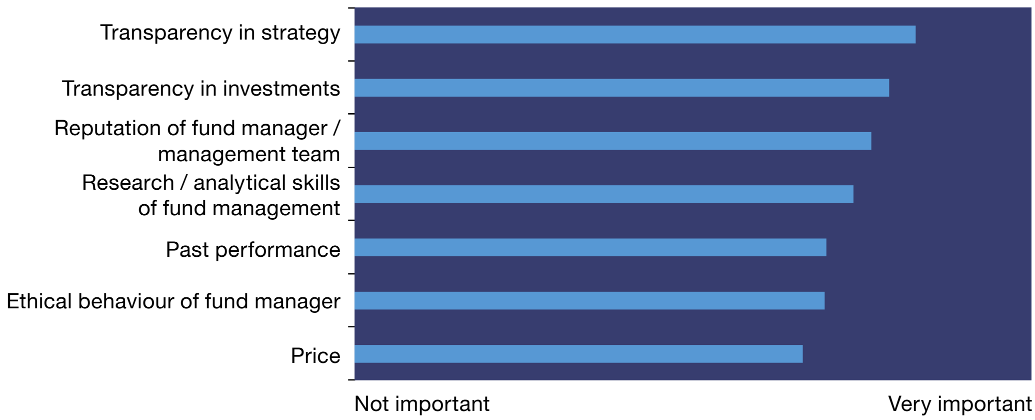


Investing in real estate has traditionally been in a form of direct investment, however real estate funds are a new alternative investment instrument in the Finnish market that is fast becoming more attractive - over 60 % of the survey participants expect their real estate funds to increase over the next three years as the array of financial products grows. The main growth is expected from real estate funds investing outside of Finland.

Decision-making criteria among investors

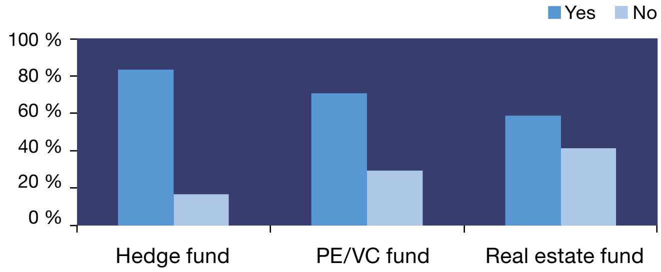
The most important factors for investors when making investment decisions are transparency in both strategy and investments.

Importance of different factors when considering an investment



Investors seem to believe that hedge funds, in particular, take uncontrolled risks from time to time. The same is true for PE and real estate funds, but the results are not as skewed.

Do you believe hedge funds, PE/VC firms and/or real estate funds take uncontrolled risks occassionally?



When investors were asked for their feedback on being cautious about the risks of hedge funds and not fully understanding the claimed benefits (low risk and absolute returns), the results were not consistent. Many investors indicated the high fee structure of the hedge funds as one reason for being cautious, and others acknowledged that there was little or no transparency in the fee structure (i.e. no clear, concise breakdown of charges). This ultimately deterred some investors.

The total expense ratio (TER) has been developed to provide much more accurate information about the cost structure and is already being used by some asset managers. Investors did note that they were fairly well informed about the nature of hedge funds, however many also stated that they did not fully understand the benefits of the asset class and were, as a result, overly cautious about the risks involved. Some believed that certain investors were still cautious about investing in hedge funds, as they are still seen as ”black boxes”. This seems to be true especially when considering foreign hedge funds. Some criticised that many hedge funds, especially foreign hedge funds, were only established to take advantage of the positive hype/trend in investing in hedge funds, and they were even claimed by some to be a marketing trick, not a genuine hedge fund that could be taken seriously.

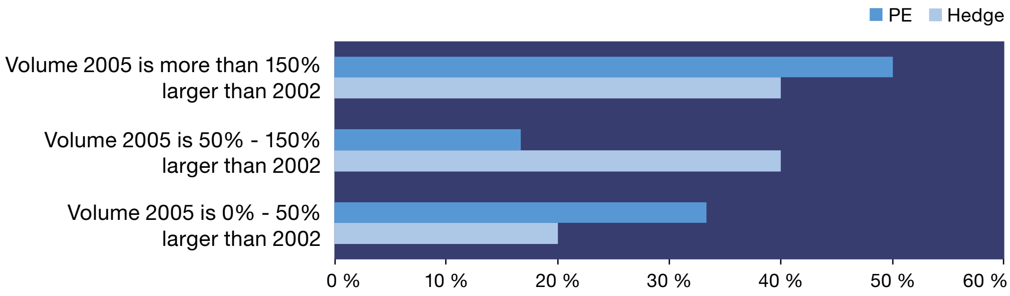
Sales channels and volume distribution of sales of Hedge Funds

Based on our survey results, the main distribution channels for hedge funds are branches and face-to-face sales. The telephone was seen as the major channel for existing customers and face-to-face meetings were used for first-time investments to share information on hedge funds. The interviewed hedge fund providers stated that the Internet is still a minor distribution channel, however all recognised that its importance is expected to increase.

Volume development of fund providers of alternative investments 2002–2005

In general the total volume of funds and assets under the management of the interviewed PE companies and hedge fund providers has grown substantially during 2002–2005. Half of the PE companies, and 40 % of the hedge fund providers stated that volume has grown over 150 % during the period. Hedge fund managers believed that close to 60 % of the estimated growth has come from new customers and the remaining 40 % from existing customers. This result contradicts the global PwC Wealth Management survey in 2005, which suggested that the majority of the growth in total AUM is expected to come from existing clients.

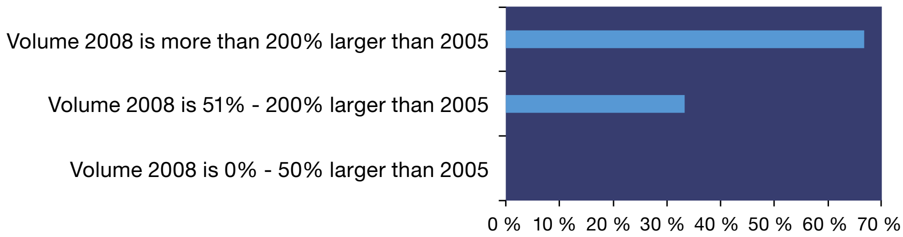
How has the total volume under your management changed during 2002-2005?



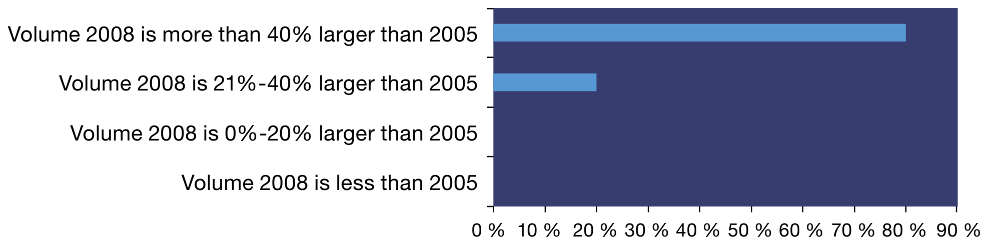
Estimated volume of funds/assets development of fund providers of alternative investments 2006–2008

During 2006–2008 nearly two-thirds of the interviewed hedge funds expect the strong growth to continue, and are planning to increase the total volume of the funds under management by over 200 %. Of the PE companies, approximately 80 % expect the volume to increase by over 40 % compared with the volume of funds under management in 2005. Interestingly enough, none of those interviewed expect the volumes to increase by 20 % or less.

Expected growth of funds under management of hedge funds during 2006-2008



Expected growth of funds under management of PE companies during 2006-2008

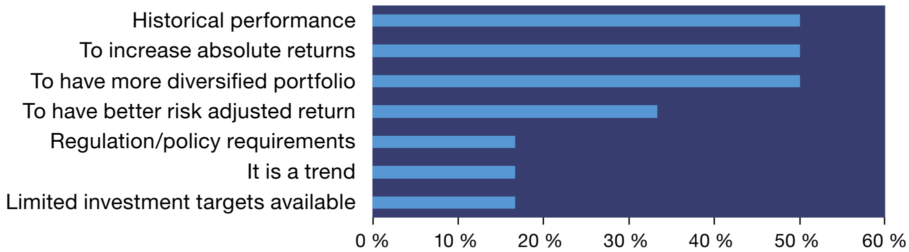


Most of the growth of hedge funds is anticipated to come from institutional investors, despite the scepticism among investors about hedge funds. Based on the survey, only about one-third of the funds under management are currently coming from retail investors. Currently, institutional investors still dominate the total share, but it is expected that both types of participant will increase their holdings in the future. A few hedge fund managers see the biggest growth potential in the future coming from the retail sector, where funds of funds have started to gain popularity. Hedge funds have set up fairly aggressive growth targets for themselves over the next few years, and in order to reach these growth targets, hedge fund providers are planning to launch new funds, actively market the old funds, utilise branch networks, have face-to-face meetings with the investors and attract new clients through good performance.

How hedge funds attract more funds in the future

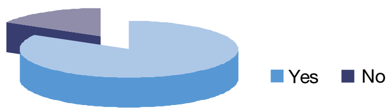
Most of the interviewed hedge funds believe that Finnish investors are going to transfer more funds from money market and direct equity investments into the hedge and special common funds in Finland. It was highlighted, however, that the future direction of funds flow depends heavily on regulation. Based on the survey, the main reasons for the move to the new funds are the historical performance of the instruments, the need to increase absolute returns and the need to have more diversified portfolios. Other reasons for the potential increase in the popularity of the hedge and special common funds in Finland included the need of retail customers to have more growth potential and to have better risk-adjusted return. For institutional investors regulation changes, internal policy requirements and limited availability of investment opportunities were also mentioned as reasons. It was also noted that the trend was to have part of the portfolio invested into different types of alternative investments. One comment was also made that oversized returns were only available via niche investments where the information flow is not immediate (i.e. in PE and emerging markets).

The main reasons that Finnish investors increasingly shift more funds from money market and direct equity investments into hedge and special common funds - view of hedge funds



Around 80 % of those interviewed within hedge funds felt that the lack of knowledge and/or awareness of alternative investment products is still limiting the growth and/or offering of alternative investments in Finland.

Do you feel that a lack of knowledge and/or awareness of alternative investments is limiting growth in Finland?



Of all the interviewed PE companies, about 70 % expect that there will be significantly more investment targets available in Finland in 2006–2008 compared with 2005. None of the interviewees expect investment targets to decrease in the next three years. When asked about their estimates of the number of fund management companies in Finland in 2006–2008, two-thirds of the PE companies expect the number will be more or less the same as today. None of the PE companies expect an increase in the number of fund management companies in Finland in the next three years. Based on this survey, we can expect there to be some consolidation in fund/asset management companies in the next few years. The same conclusion was reached globally in the Wealth management survey conducted by PwC in 2005.

The majority of PE companies indicated that their current available funds for investments are sufficient to support their current investment plans for 2006–2008. However, new fund raising is planned and needs to take place in the next two years for many funds to support the growth targets of many PE managers. Fund raising will probably include funds like PE funds, VC funds and mezzanine funds.

The opinions of PE companies were distinctly divided whether the funds available from Finnish institutional investors for PE and VC investments will be sufficient in the future. Half of the PE companies interviewed did not expect the PE and VC funds that invest in Finland to gain a significantly bigger share of Finnish institutional investors' portfolios. The other respondents clearly expect that enough funds will be available, and are not concerned that these investments will grow too large in Finnish investors' portfolios over the coming years.

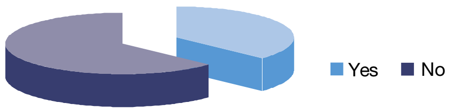
5 Products offered

5.1 Development of products offered

Competitiveness of local Finnish funds – the view of investors

When investors were asked for their views on local versus foreign providers of alternative investment funds, less than 40 % thought that local hedge funds, PE and VC funds, and real estate funds were as competitive as international providers. The other investors thought that local providers were not as competitive because the performance of foreign funds was better. Other reasons given for local hedge funds not being as competitive as their international counterparts included the small local market size, and legal and tax benefits from which foreign funds can benefit. Other reasons that favour international providers could possibly be their use of sophisticated systems, the advanced quantitative methods used and broader access to information flows.

Are local hedge funds, PE/VC funds and real estate funds just as competitive as international providers?

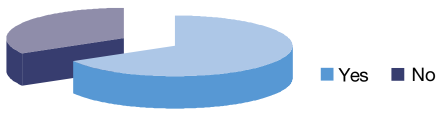


Activity and influence of the hedge fund provider as an investor

Approximately half of the hedge fund respondents classified themselves as proactive investors who sought out and actively communicated with the management of target companies. The rest of the hedge funds indicated that they did not actively communicate with the management of target companies.

None of the interviewed hedge funds thought that Finnish hedge funds exercise any considerable power over domestic investment targets, whereas two-thirds of those interviewed thought that international hedge funds exercise considerable power over Finnish investment targets.

Do international hedge funds exercise considerable power over Finnish investments targets?



The survey also asked how demands and requirements of hedge fund managers on target companies' top management differ (if at all) from those of ordinary direct equity investors. The majority of the hedge fund providers did not see any significant difference between the demands and requirements of hedge fund managers and those of ordinary direct equity holders on target companies' top management. Some respondents, however, thought that the hedge fund managers' demands and requirements were clearly different, being less likely to alter their investment relations because of minor disagreements.

Private equity funds – strategies and focus today as well as future development trends

PE companies that were interviewed were asked to define their funds. Two-thirds of the companies defined their funds as industry specific. Others described their funds as regionally operating funds, or country specific funds.

Some of the survey results indicate that in the future PE funds will focus more intensively on international operations (i.e. international funds), investing in turnaround companies, and become geographically focused instead of being solely industry specific. It was also mentioned that the rules and strategy of PE companies will often be more flexible than today.

PE companies were also asked to estimate the role industrial buyers would play in the M&A market during 2006–2008 in Finland. Over 65 % believed that industrial buyers will be as active in M&A over the next three years as they are today and one-third believe that industrial buyers will be more active, which indicates that overall M&A activity will increase over the next few years. Increased competition has been seen to drive prices higher, making it more difficult to create value through M&A for PE companies.

5.2 Challenges when offering different products

Arguments in favour of alternative investments – the view of investors

Investors were asked to give their reasons for increasing investments in hedge funds, PE and VC funds and real estate funds. The most common argument was to diversify the portfolio. Low correlation, low volatility and absolute return targets were seen as other reasons. A better return than from money markets was also mentioned.

The most common reason for increasing investments in PE and VC funds was the high-expected return. Furthermore diversification, low correlation with other instruments, and fairly good transparency were mentioned several times as reasons for the increase.

Diversification was seen as the most common argument for increasing investments in real estate funds. Furthermore good returns (better than the money market) and considerably better liquidity than in traditional real estate were seen as additional factors when investing in real estate funds. A good hedge against inflation was also mentioned as a key reason.

Arguments against alternative investments – the view of investors

In addition to listing reasons in favour of increasing investments in hedge funds, PE and VC funds, and real estate funds, investors were asked to suggest reasons why NOT to increase investments in those funds. The most common reason given not to increase investments in hedge funds was the low return compared with the risk. Furthermore, the poor transparency and the high cost of the funds were seen as additional reasons for investors not to invest in hedge funds. Current regulations (i.e. investment classification rules by the Insurance Supervisory Authority, ISA) and high personnel risks were also mentioned as reasons for not investing in hedge funds.

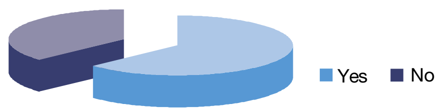
The main reason given not to increase investments in PE and VC funds was the poor liquidity of the investment instrument. Furthermore, historic fluctuations in the investment return and a lack of transparency of the funds were seen as additional reasons. These funds were also seen to require a lot of work with their lengthy legal procedures and documentation, and lastly, a long investment time was also cited as a reason.

The most common reason for not increasing investments in real estate funds was the overheated real estate market in Finland and the threat of the bubble bursting at some point in the future. Furthermore the bad liquidity, high costs and lack of transparency of the funds were seen as other reasons not to invest in real estate funds. The high ratio of debt in the real estate funds seems to create more correlation with interest rates, and is seen as a further reason not to invest in them.

Information about the funds received by the investors

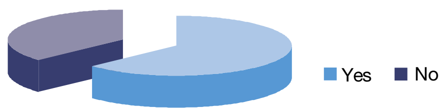
Around two-thirds of the investors interviewed claimed to know how the fund managers at the hedge, PE and VC and real estate funds had valued their positions in the various instruments. It is still quite a big portion (around one-third) of investors who stated that they did not know how the valuations are done.

Do you know how fund managers in your hedge, PE/VC and real estate funds value their positions in various instruments?



The need for better, more concise reporting by asset managers was seen as an area listed for improvement, as two-thirds of the interviewed investors received a lot of information from the hedge fund, PE and VC fund, and real estate fund managers, but the information was not seen relevant to support their investment decision making. Many of the investors would have liked to receive more information, especially about the ratio of debt in the fund (i.e. in the real estate fund), the track record of the fund, the contents of the portfolio and the experience of different actions taken by fund managers, together with information about the fund managers. It was also noted that the pricing information from hedge funds is in most instances being delivered too slowly. Information about the funds seems to be adequate in many cases at the time of the investment, but it is not meeting the expectations of many investors on an ongoing basis. In general, the interviewed investors would like to see better transparency with all funds. More information about risk management of the funds, vacancy rates of real estate funds, enumeration of employees, strategy, valuation and the general business environment was also noted as needed information.

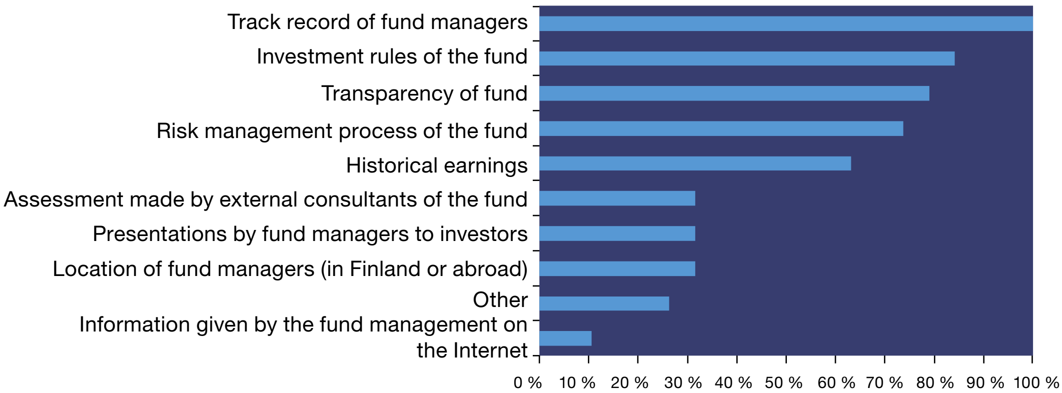
Do you receive all the necessary information from hedge fund, PE/VC fund and real estate fund managers so you can make your investment with full confidence?



Investors' views on important issues when considering new investments

Investors were asked about which issues they see as being very important when considering new investments. All of the interviewed investors perceived the track record of the fund managers to be a very important factor when considering a new investment. The majority of the interviewed investors also saw the investment rules, transparency and the risk management process of the fund as important issues when considering a new investment. Around one-third of the investors regarded the assessment made by external consultants to the fund, investor presentations by fund managers and the location of fund managers (in Finland or abroad) as other important factors when considering a new investment. On the other hand, information given via the Internet by the fund manager was often not seen as adequate and very informative by many investors.

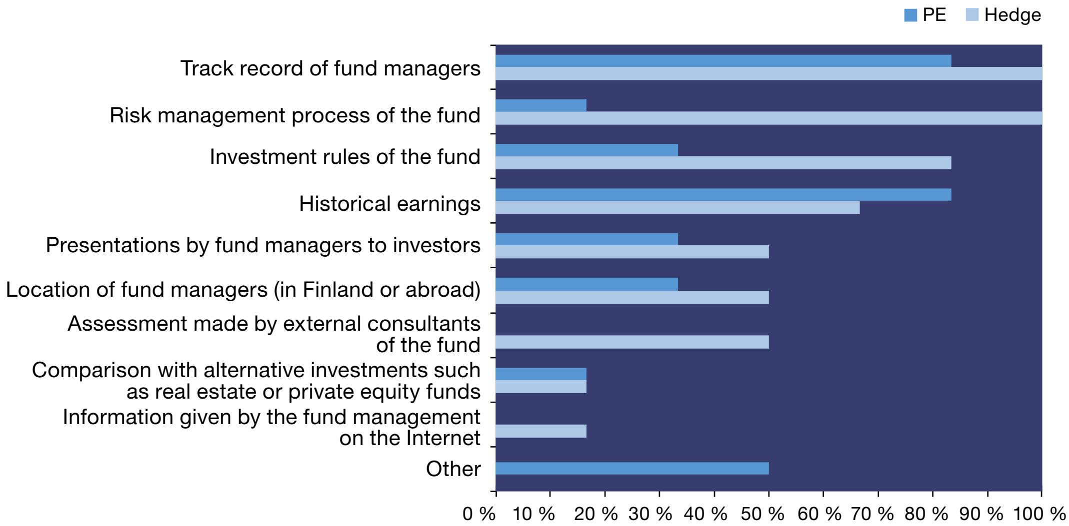
Important issues when considering new investments



Assumptions of fund managers regarding important issues when investors are considering new investments

Hedge fund providers and PE companies were asked what issues they thought investors saw as very important when considering investing in a new fund. The hedge fund providers' views were very similar to investors' own views in that the track record of the fund managers and the risk management process of the funds are very important issues. The majority of the hedge funds also regarded the investment rules of the fund and the historical earnings as very important. PE companies' responses were somewhat different as they thought that investors saw the track record of managers and the historical earnings as very important issues. But surprisingly, the investment rules of the fund and particularly the risk management process of the funds were not considered by many to be that important.

Important issues for investors in investment considerations - view of Hedge & PE



6 Challenges for investors and fund providers

6.1 Internal challenges facing investors and fund providers

One of the most common internal challenges that investors stated was to find enough skilful personnel, and to be able to pay them attractive salaries in order to retain them. Another major challenge is the ability of the people as well as the company to change. The strict ISA rules and the onerous reporting were also mentioned as significant internal challenges. Furthermore, the different legal agreements for each investment case (especially concerning PE investments), and the constant profit pressure combined with the low risk profiles of investments are internal challenges for many investors.

Some hedge funds stated that one major challenge related to questions of how some instruments are valued. Hedge funds cited challenges with the administration of new instruments, and managing the growth of the operations as such. Major challenges were also noted on how to reach the performance targets of the funds, as well as educating the fund sales people.

Certain PE companies stated that their main internal challenge is the large size of the company, which can cause poor information flow and diminish entrepreneurship. Time-consuming processes were also mentioned as a challenge, and a few companies stated that there were no major internal challenges.

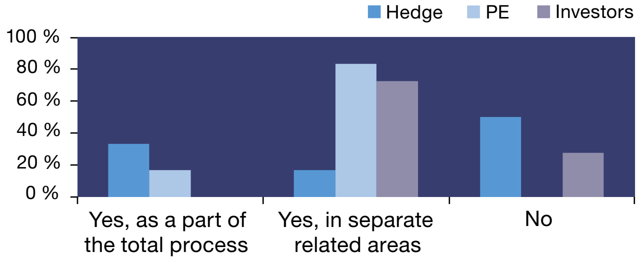
Use of advisors in business development and investment decision process

All of the PE companies interviewed claimed to use advisors in their business development projects, and legal and tax advisors were used most often. Many of the PE companies also claimed to use audit-related services and environmental advisors. Over 80 % of the PE companies also used auditors in the investment project consulting, while other consultants used were tax and legal, financial, environmental, IPR (Intellectual Property Rights), change management, public relations and human resource management consultants.

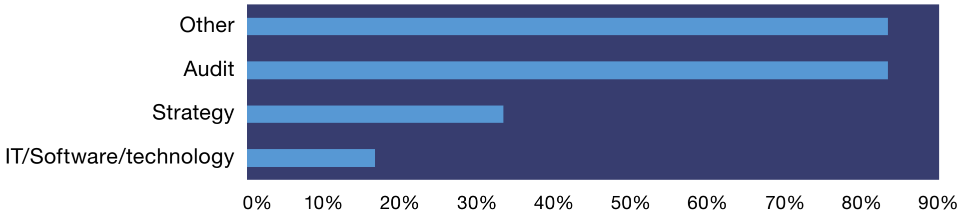
Only half of the interviewed hedge fund providers stated they used advisors in business development projects, in IT, strategy, tax and risk management, and due diligence areas.

The interviewed investors mostly used tax, legal and strategy advisors, but occasionally used advisors for risk management, and audit and investment decisions concerning hedge, and PE and VC funds.

Use of advisors in business development projects



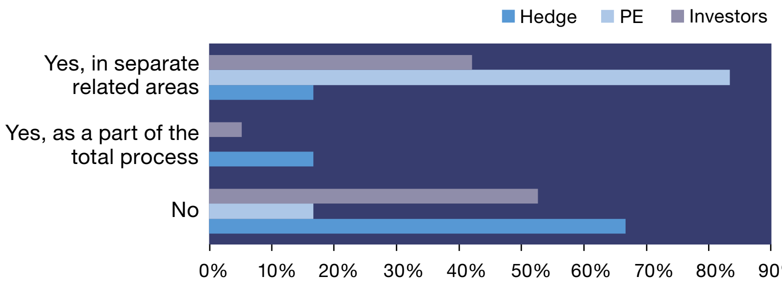
Type of consultant used by Private Equity companies in investment projects



Use of advisors when considering new investment / fund projects

The majority of the PE companies interviewed claimed to use advisors in separate related areas when considering new investments. The figure for investors and hedge fund providers was around half, and one-third respectively. From those who claimed to use advisors, all of the PE companies and hedge fund providers said they had used legal and tax advisors, and many of the PE companies also used placement agents (investment banks). The advisors that investors used most frequently were tax/legal and strategy. Advisors are also used in the areas of risk management, IT and actuarial services.

Use of advisors when considering new investment



6.2 Challenges coming from customers and competitors in different areas

Hedge funds – Challenges from customers

The challenges hedge funds face most frequently when dealing with institutional clients include the restrictions that clients have on risks related to portfolio allocations. The limited awareness of hedge products among institutional clients is also sometimes seen as a challenge that hedge funds face. Fierce international competition, regulation and the credibility of the hedge funds in the eyes of institutional clients are other challenges mentioned.

Hedge funds stated that the main challenge with private customers is their lack of knowledge of the instruments. It is hard to explain the reasons for low returns of hedge funds in a way that private customers would understand them.

Future development of competition among funds in Finland

All PE companies agree that the interest among institutional investors in alternative investments such as hedge funds and PE and VC has increased over the last few years, and this trend looks set to continue. All companies indicated that not only has investors' interest increased during the last few years, but so have their expectations and consequently also the capital invested in these alternative investments.

PE companies have quite different expectations concerning the future development of competition among funds in Finland over the next two years. There was strong opinion that the competition in Finland is quite fierce at the moment and that the existing regulations are not helping to reduce overall market pressure on funds. However, most companies expect competition to remain the same or even increase slightly. A few respondents indicated that some consolidation would take place among PE companies in the near future.

The harsh competition amongst hedge funds will continue in the near future, but the level will most likely decline from the recent highs. International competitors entering the Finnish market will ensure that investors have the possibility to allocate their capital better due to the increased supply of investment possibilities. However, some providers do not expect new international competitors to enter the Finnish market and state that the interaction with local authorities and their requirements are seen as too restrictive for new entrants. A few respondents also expect some mergers to take place, which would undoubtedly change the competition landscape.

Competitive advantages

An essential characteristic that hedge fund providers stated as being an advantage over fellow competitors related to the investing process itself. They found that a good knowledge of which stocks to pick and a talented investing process, which compensate for a high-risk adjusted return, were key to attracting investors. Good customer service, a diverse branch network, experience and a strong brand were also pointed out as critical qualities.

In analysing the individual characteristics that would assure Finnish PE companies of success in the future, three points were clearly identified - their own good track record, their skilful personnel and excellent networks both nationally and internationally. Each of these would give them a distinct competitive edge. Other factors that were mentioned included well-working and long-standing investment processes and strategies, as well as good industry experience.

7 Local versus global issues for investors and fund providers

Local versus global issues for investors

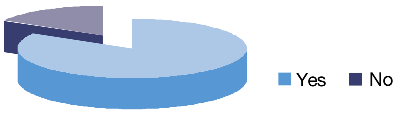
Investors in Finland operating in the alternative investment sector are constantly evaluating the advantages and disadvantages of investing in either domestic or internationally managed funds. According to the majority of the Finnish investors, there seem to be various factors in the Finnish national regulations regarding PE, VC, hedge funds, and real estate funds that discourage domestic counterparties; i.e. Finnish hedge funds known as special common funds (non-UCITS) cannot use leverage, but international funds can.

In some situations, Finnish alternative investment funds may have difficulties attracting foreign investors due to unfavourable tax issues, and it is clear that a failure to attract foreign investors to a fund can also influence the keenness of Finnish investors to invest in such funds.

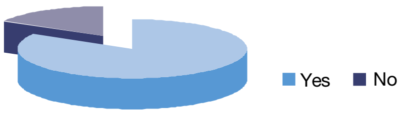
Local versus global issues for hedge funds

The majority of Finnish hedge funds seem to invest in overseas instruments when managing their assets despite the associated risk. Over 80 % of the Finnish hedge fund managers are of the opinion that investing in foreign instruments incurs more risk than investing in domestic instruments, and despite that over 80 % of the hedge fund managers are still planning to increase their investments in foreign instruments.

Does investing in foreign instruments contain more risk than domestic ones?



Are you likely to increase share of foreign investment in your portfolio?



The managers of the hedge funds have several reasons for increasing their foreign exposure within their hedge funds. One reason given is that investors like to, and even require the funds to be internationally diverse. Another reason is that fund managers are keen to decrease the volatility within the fund, again through international diversification. A third reason seems to be a very well functioning Finnish equity market; i.e. it is difficult to find underperformers on the Finnish stock market, but it is much easier to find underperformers where international diversification is included in the fund operations.

To achieve successful international diversification, the Finnish fund managers have to skilfully manage risks such as political, legal and tax risks. The Finnish fund managers mitigate these risks in a number of ways. All the funds have very clear, strict internal policies on how to process new instruments within their funds, and most of the Finnish funds have policies detailing how custodians are selected when investing internationally, thereby mitigating the risks involved.

8 Legal issues for investors and fund providers

For both investors and fund providers the basic legal framework of alternative investment instruments consists of the Companies Act, the Partnerships Act, the Securities Markets Act, the Mutual Funds Act and the Consumer Protection Act.

The Mutual Funds Act classifies collective investment undertakings into two categories. The first category covers the collective investment undertakings or UCITS as laid down in the Council Directive. The second covers other foreign collective investment undertakings including both non-UCITS (herein special common funds) and other foreign collective investment undertakings.

Hedge Funds

The term hedge fund is not defined in the Finnish legislation. According to the Mutual Funds Act certain regulations (on the investing strategies, issuing policy etc.) of the funds do not apply in the case of a special common fund within the meaning of the act, including funds informally known as hedge funds. Therefore the legislation gives the possibility to use a broader range of instruments for the special common fund.

The FIN-FSA approves the articles of the funds that are sold in Finland and therefore also sets limits on the rules of all common funds, UCITS and non-UCITS. The authorities may also impose more specific provisions, grant exemptions from the rules and give instructions for the interpretation of the Mutual Funds Act and its rules. If applicable, the Mutual Funds Act requires a fund to prepare a prospectus and have it approved by the FIN-FSA.

Private Equity and Venture Capital Investments

There are no special laws or rules governing the PE and VC industry in Finland. The Mutual Funds Act covers only funds that are incorporated as limited liability companies. Also, the Mutual Funds Act covers only the open-ended funds, while most of the PE and VC funds are closed-ended. Neither is the capital of a PE and VC fund variable within the meaning of the Act. Therefore in most cases, the Mutual Funds Act is not applicable for PE and VC funds. However, if the fund is marketed towards individual consumers, the Consumer Protection Act should apply.

The usual structure in a PE and VC investment is to establish a fund as a limited partnership[5], where a limited company (the management company) is the general partner and investors are the limited partners. The parties enjoy wide contractual freedom in this structure. The basic agreement is the partnership agreement, which has to be registered in the Finnish Trade Register, and as a result it then becomes public information. In the more complex structures it is often necessary and in the interest of the investors to agree on the rules of the fund in the more specific (and confidential/nonpublic) agreements, such as:

- Co-investment agreements,
- Investment advisory agreements,
- Management agreement.

[5] *Limited partnership: in Finnish “kommandiittiyhtiö”, abbreviation “ky”.*

In general, the rules of Securities Markets Act do not cover PE funds, because the Act requires that the shares are assignable. For that reason the obligation to prepare a prospectus within the meaning of the act is not applicable. In exceptional cases, when the Articles of a closed-end PE fund give the possibility to freely assign the shares, it is possible that the Securities Markets Act also covers the PE fund. However, according to FIN-FSA, there is an obligation to prepare a prospectus under the conditions of the Securities Market Act only if the target group for the fund is wide, i.e. if the fund is marketed to at least one hundred potential investors. In Finland a target group of more than one hundred investors is rare, however it is still very common to prepare a prospectus or a private placement memorandum, at least in the larger PE funds. The only difference is that when there is no obligation to prepare a prospectus, the prospectus or private placement memorandum does not have to be approved by FIN-FSA.

Real Estate Funds

There are no special Finnish rules to cover funds in Real Estate Investment Trusts (REITs). The need for REITs has been widely debated in Finland in the last few years and a working group set up by the Ministry of Finance is currently considering whether tax-transparent or tax-exempt REITs could be introduced into Finnish legislation. As a matter of fact, Finnish legislation currently recognises real estate funds in the form of a limited liability company in the Act on Real Estate Funds, but due to the fact that such a fund would be fully taxed, no such funds have been established yet. There are a few real estate funds in Finland in the form of limited partnerships, and currently no restrictions on foreign ownership of real estate exist in Finland.

The prospectus and private placement memorandum (mentioned above) is also applicable in the case of a real estate fund. The reasons for preparing a prospectus must therefore be investigated case by case, but usually a private placement memorandum is still prepared regardless of whether it is compulsory or not.

9 Taxation issues for investors and fund providers

9.1 Tax efficient fund structures

Taxation is a key issue in the structuring of a PE fund, a real estate fund or a hedge fund. From the investors' perspective, it is critical that the structure avoids any tax leakage at the fund level so that they are not subject to a higher tax leakage than if their money was invested directly in the underlying portfolio investments.

The objective of minimising any ”additional” tax leakage, versus a direct investment, can be achieved via the following alternative structures:

(i) Transparent funds. These funds will be transparent for tax purposes so that they will not be subject to tax, but their income will be *pro rated* to the investors and taxed according to the tax status of the investors. Examples of these transparent funds include Guernsey/Jersey Limited Partnerships, UK Limited Partnerships as well as onshore Limited Partnerships such as Dutch CVs or Danish K/Ss.

Finnish PE houses have traditionally used a Finnish Limited Partnership as the fund vehicle. However, as a taxable presence (permanent establishment) is created for foreign investors in a Finnish LP, foreign investors have been reluctant to invest in such structures. However, following a recent amendment in the tax law (effective from 2006), foreign investors are now taxed as if they had invested directly into the underlying portfolio of companies. This means in practice that investors will not be taxed on their portion of capital gains realised by the Fund, provided that the foreign investor is deemed a ”Tax Treaty subject”.

(ii) Non-transparent funds. These funds will be in the form of a corporation, but (according to its tax status) certain key elements of its income, such as capital gains, will be tax exempt. In addition, to achieve the objective of a tax-efficient fund structure requires that there are no withholding taxes on the distribution of profit and that capital duties are minimised.

Such corporate funds (with a proven track record) include Dutch BVs and Luxembourg SCAs. Hedge funds are sometimes corporations situated in Bermuda, the Cayman Islands, or in other areas with favourable offshore tax legislation. Luxembourg has recently created a SICAR vehicle, which offers interesting tax opportunities. For Finnish investors, investing in a non-transparent fund may offer them very attractive tax treatment (see Section 9.2).

(iii) Mutual funds. These funds will be in a form of a mutual fund or other form that has a fully exempt tax status according to the tax law of its residence. For example, Finnish hedge funds are generally created as special common funds, which are tax exempt by law. However, such entities might not be able to benefit from Tax Treaties and, furthermore, any withholding taxes may end up as a final tax burden, as such taxes cannot be credited since the entities do not pay taxes.

In addition to the general objective of trying to avoid ”additional” tax leakage compared with a direct investment, the fund structure may have other tax-related objectives. For real estate funds, such objectives may include

- minimisation of corporate tax on rental income (this can be enabled using internal and external leverage);
- elimination of withholding taxes within the structure (using a feasible holding structure);
- elimination of the taxation of the capital gain on exit (using a feasible holding structure).

For hedge funds, the objective might also be to defer the taxation of investors until the fund distributes income, or the investor disposes of the shares of the hedge fund. This would generally require a non-transparent structure and that Controlled Foreign Corporation or equivalent legislation would not be applicable.

9.2 General Issues On the Taxation of Finnish investors

The taxation depends greatly on the tax status of the investor. For taxable Finnish investors, the tax treatment generally depends on whether the fund is regarded, for Finnish tax purposes, as either:
• a partnership or
• a corporate or
• a mutual fund.

If the fund is a partnership, the pro rata share of the Finnish investor is generally taxable income in the Finnish taxation of the investor. Any withholding taxes on interest or dividends received by the fund can be credited under certain conditions.

If the fund is a corporation, the Finnish investors are generally taxed when the fund distributes its profits. The profit distribution may even, under certain conditions, be completely tax-exempt for a Finnish investor.

If the fund is considered a mutual fund, the Finnish investors are again taxed when the fund distributes profits and the profit distribution is generally fully taxable. If the fund is an accumulating fund (that does not make any distributions), then the investors are generally only taxed when they sell their shares in the fund.

In certain situations, it might even be possible that the fund is regarded as a pass-through entity so that a Finnish investor is only deemed to own a portion of the underlying investments directly, and is then taxed accordingly.

When investors consider investment in a fund, they should investigate not only the Finnish tax issues but also the taxation of the fund vehicle, and the taxation of all the cash flows in the structure in order to determine that the fund structure has a suitable tax profile for them. In some cases, the analysis might show that it may be more beneficial to invest via a parallel vehicle or a feeder vehicle than to invest directly into the ”main fund”.

10 Decision making, valuation and pricing issues

Investment management organisation of investors

Interviewed investors were asked to describe how they organised their investment management business. The answers indicated clear differences between larger-volume investors (according to assets under management) and smaller-volume investors. One common factor is that the investment management is segregated. The bigger investors divided their organisation into different teams, and/or among different people that are responsible for one investment area. The smaller investors, however, kept parts of the investment organisation within the company, and outsourced all the other investment areas. For almost all the respondents, equities and money market instruments are handled in house, whereas PE and real estate are outsourced to external asset managers.

Investment meetings are arranged every year for all investors where preliminary allocation plans and investment budgets are determined. In addition to that, most respondents had regular meetings (monthly, weekly and even daily), where risk management issues and decisions to invest in larger investments are discussed and agreed upon. In most companies the Board of Directors arranges these meetings but for certain investing companies these meetings are arranged by the heads of the different investment departments (i.e. equities, money market, etc.).

For the smaller respondents, investment decisions are almost always centralised, and made by the Board of Directors. For the investors that have a bigger amount of assets under management, the party making the investment decision depends largely on the size of the allocation in question. Where the biggest investment allocations are made by the Board of Directors, the smaller investment allocations might also be made by the individual teams or the individual heads of investment areas.

Investment management/decision process of investors and fund providers

All of the investors and fund providers interviewed were asked to describe their investment management/decision process. A common trend was apparent among the investment management processes for all the responding hedge fund providers, as they all clearly chose a strategy that minimised the risk in their investment positions. Risk reduction is achieved by selecting a diversified array of instruments, and taking long and short positions to achieve targets set in alpha-values and other risk indicators. Essentially, most hedge fund providers follow their investment management process per their strategies and guidelines that have been established for all investment decisions.

For all the interviewed PE companies, the investment management process is very similar. The process is clearly more uniform than for the hedge funds, due to the different nature of their investments. All the interviewed companies stated that the number of investments that are actually made is less than 15 per year, with the yearly average being 5 per company. Even if that amount of investments is made annually, the number is still very low considering the amount of applicants is approximately 600 per PE company each year.

All the PE companies divided the process into three distinct steps, along with a fourth step that constitutes the final investment transaction. The primary step in the investment management process for PE companies is analysing and selecting applicants. This is followed by a more detailed investigation of approximately 10 % of the investment targets. And before the final investment decision is made, the PE company has to perform due diligence, which is the third step in the process.

The investing companies make their long-term decisions of their investment allocation yearly. Issues discussed and decided at these meetings are the yearly investment plans, including allocation of investment assets, delegation of investment authorities, and risk-taking limits. For some of the interviewed investors a special investment committee meeting (that is comprised of directors and heads of different investment areas) is held, and in these cases the committee needs approval for its decisions from the Board of Directors. For the other investors, the Board of Directors does the yearly investment plan directly.

The investment decision process is further continued with the help of monthly and weekly meetings. Issues such as investment allocations and operational investment decisions, as well as questions concerning risk management are raised. These meetings are often set up independently for each different investment area, and may only include the presence of the persons responsible for the investment decisions in that specific area. In some cases, the decisions made in these monthly and weekly meetings need the approval of the Board of Directors. In the daily investment process, the portfolio managers make their own investment allocation decisions based on limits and plans set out by the Board of Directors.

The parts of the investment process that are outsourced to external players are discussed comprehensively once or twice per year with asset managers. In the daily and weekly investment decisions, the external asset managers inform the companies of market situations and investment decisions. The interviewed investors also often make use of outside research and analysis to help with their decision-making in investing.

Investment valuation/pricing process of investors and fund providers

All of the interviewed investors and fund providers were asked to describe their investment valuation/pricing process. Investment valuation and pricing for hedge fund providers is principally based on market prices, obtained every day from market data providers. Most instruments can be valued and priced with the help of this regularly updated market data, with the exception of more exotic instruments and, for example, swaps for which the pricing requires a theoretical basis for some investors. Some investors used special computer programs, which were designed solely for the valuation of portfolio models.

Differences in the process of investment valuation for PE companies are mainly a consequence of the fact that they are working in diverse business areas and focus on different issues depending on their investment targets.

The valuation and pricing process of the PE company is mainly comprised of a preliminary valuation plan prior to the investment being made. The plan is devised for every investment target and is based on current market values, for which multiples, exit scenarios, demand calculations and risk factor assessments are calculated. The valuation plan is then compared with the actual value created (i.e. budget vs. actual) when the investment return eventually materialises.

The principles of valuation of the majority of investors' investments are based on guidelines established by EVCA (European Private Equity & Venture Capital Association). A large part of their investments are in shares of listed companies, whose market prices are readily available on a daily basis. Third parties were involved in the pricing and valuation process for all interviewed investors, whether as market data providers or as producers of the valuation in full.

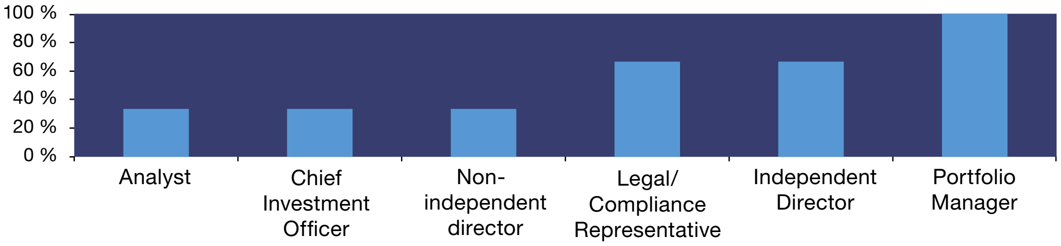
External consultants are used in the valuation and pricing of the investments. But the pricing and valuation of real estate investments is outsourced in full, and specialised real estate consultants normally provide that. When the valuation and pricing is done in house, the back-office personnel usually perform it. In certain situations, the interviewed investors have established a special investment group and they take care of the valuation of the investments instead of the back-office.

The investors indicated that their investment positions, especially in equities and money market instruments, are monitored daily. This applies to valuations enacted both in house and/or by external service providers. Only a few investors monitor these positions on a weekly basis. However, instruments with a fixed income are monitored less frequently, even on a monthly basis.

Other valuation issues for investors and fund providers

Most of the hedge fund providers and investors claim to have established policies and procedures to address the valuation of their portfolios. Half of the interviewed hedge fund providers claimed to have a formalised pricing committee and the other half did not. Those who did not have a formalised pricing committee said that they are not even considering one, and those who did have a committee were asked about the members that comprised it. For all of the funds, the portfolio manager was one of the primary members of the committee. Many had an independent director and legal / compliance representative, and some also had an analyst, chief investment officer or non-independent director in their committee.

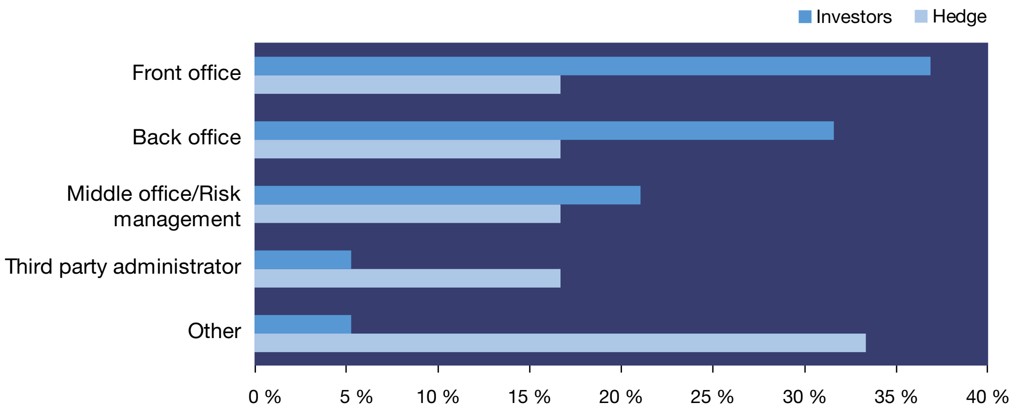
Who are the primary members of the pricing committees in hedge funds?



Investors and hedge funds were asked who has the primary responsibility for determining a portfolio valuation. From the chart below it is evident that there is a large difference of opinion, however the front office was the most common department responsible among investors. Hedge fund answers were very divided.

Hedge funds were also asked about who is primarily responsible for approving the portfolio valuation. Results indicated that the responsibility is addressed by different people in different companies; i.e. the CEO of the fund company, the portfolio manager, the administrative director, the third party administrator, the middle office / risk management and the front office.

Primary responsibility for determining portfolio valuation

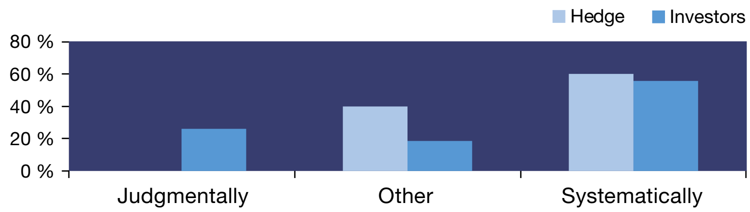


Determining the fair value of non-listed investments is very important. Around a quarter of the interviewed investors indicated that they valued non-listed investments using their judgement; i.e. follow up of unofficial markets for non-listed equities, consulting with auditors and committee decisions. In some cases valuations were based on multiples of the amount of the initial investment.

Around 60 % of investors and hedge funds said that they valued non-listed investments systematically; i.e. valuations were based on the last official net asset value, values given by the funds, and Reuters or Bloomberg information. For real estate valuations, external valuations were used and were made only once a year or sometimes less frequently. Hedge funds said that systematic valuations were based on internal valuations, brokers' valuations or Bloomberg information.

Less than 20 % of investors and around 40 % of hedge funds used another method for determining the fair value for non-listed investments other than judgmental or systematic valuation. Other valuation techniques for investors include the following: establishing the "sell price" with consideration of the prudence principle, using the last closing price or historical acquisition price, utilising information from other companies, and using the book value. Other valuation techniques for hedge funds include using third party administrators, and using an objective pricing method (required by authorities and approved by the board of directors).

How is fair value determined for non-listed & non-actively traded investments?



11 Risk management issues facing investors and fund providers

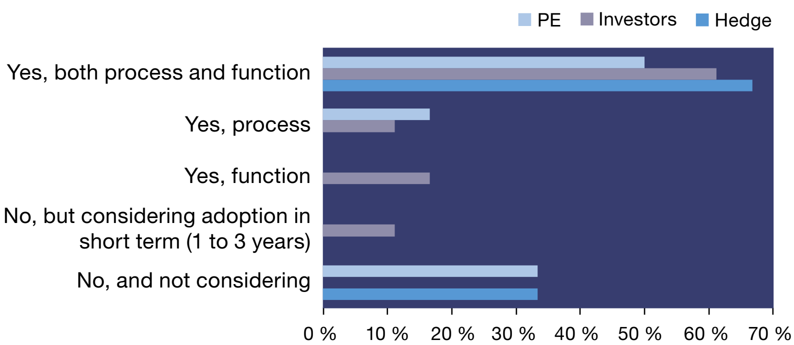
Enterprise Risk Management (ERM) has gained popularity in companies across all industries. The financial industry has traditionally been at the forefront when it comes to financial risk management issues. However, some manufacturing companies may now be ahead in terms of implementation of an Enterprise Risk Management process that also includes risks other than those related to financial products, assets and markets (in other words strategic risks, human resources risks, image risks, etc.). Recently, Basel II requirements have put pressure on operational risk management issues in many financial companies, and therefore operational risks are now usually cited as a risk category in these firms.

Many financial companies still refer to Enterprise-wide Risk Management when they talk about a firm-wide view of their financial assets; i.e. funds under management, and risk categories attached to them (e.g. market risk, credit risk, equity risk, commodity risk, swap risk). Hence, the term ‘Enterprise Risk Management’ may be misconstrued due to the fact that various companies and people do not understand the meaning of the term in the above context.

In this survey, it became apparent that PE firms (due to the nature of their business) might use a wider perspective when it comes to ERM. However, hedge fund providers and institutional investors have also included risk categories such as personnel risks and image risks in their risk management operations. Thus it seems that the players in the Finnish Alternative Investments market have started to appreciate a wider perspective than solely the risks related to the investments and financial markets. Furthermore, investors are demanding more comprehensive risk reporting, and many corporate governance related surveys and recommendations have also included risk reporting as a top priority development area.

Nearly 70 % of the interviewed hedge fund providers, 60 % of the investor companies and 50 % of PE companies claimed to have both an ERM process and function in place.

Does your organisation have an ERM process and/or function in place?

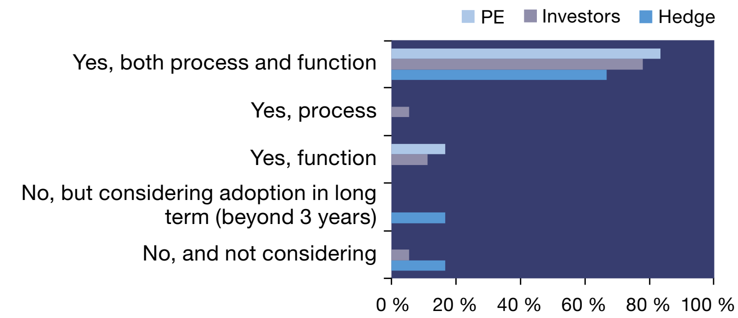


Interestingly enough, around 35 % of the PE companies and hedge fund providers stated they do not have an ERM process or function, and that they are not considering implementing one. This is a concern considering the emergence of corporate governance pressures and investors’ demands for more transparent risk reporting[6].

[6] *PricewaterhouseCoopers 2005: Survey of compliance with Corporate governance recommendations; PricewaterhouseCoopers 2006: ERM benchmarking survey.*

When it comes to the Financial Risk Management (FRM) process and function, the figures are more impressive as over 80 % of the PE companies and the investors, and around 65 % of the hedge fund providers claim to have both an FRM process and a function implemented.

Does your organisation have an FRM process and/or function in place?



The major reasons for adopting the risk management process and function are that it is regarded as a good business process, and companies feel strong regulatory and corporate governance pressure in this area.

Categorisation of risks and Importance of risk source

Around 80% of both hedge funds and PE firms claim that they categorise the different types of risk. Typical risk categories of hedge fund providers relate to investments and financial markets. In addition, many respondents also included personnel risk as a category.

Typical risk categories that related to the nature of hedge fund investments and financial markets included:
- volatility
- currency exposure
- company specific risks
- liquidity
- 'greeks' risk (related to derivative products used)
- default
- market
- interest
- credit

Risk categories that related to hedge fund operations and investment processes were stated to be:
- diversification of the portfolio
- substitutes for personnel/ the rotation of personnel in duties
- iteration in price determination
- investment operations
- IT (firewall)
- computation of value
- confirmations of payments

PE companies use risk categories such as risks related to investments (prospects, exits, partnerships etc.), as well as rating personnel as an important risk category (usually talent is a scarce resource). However, due to the nature of their business, they also categorise risks within the investment target companies with a wider scale and spectrum.

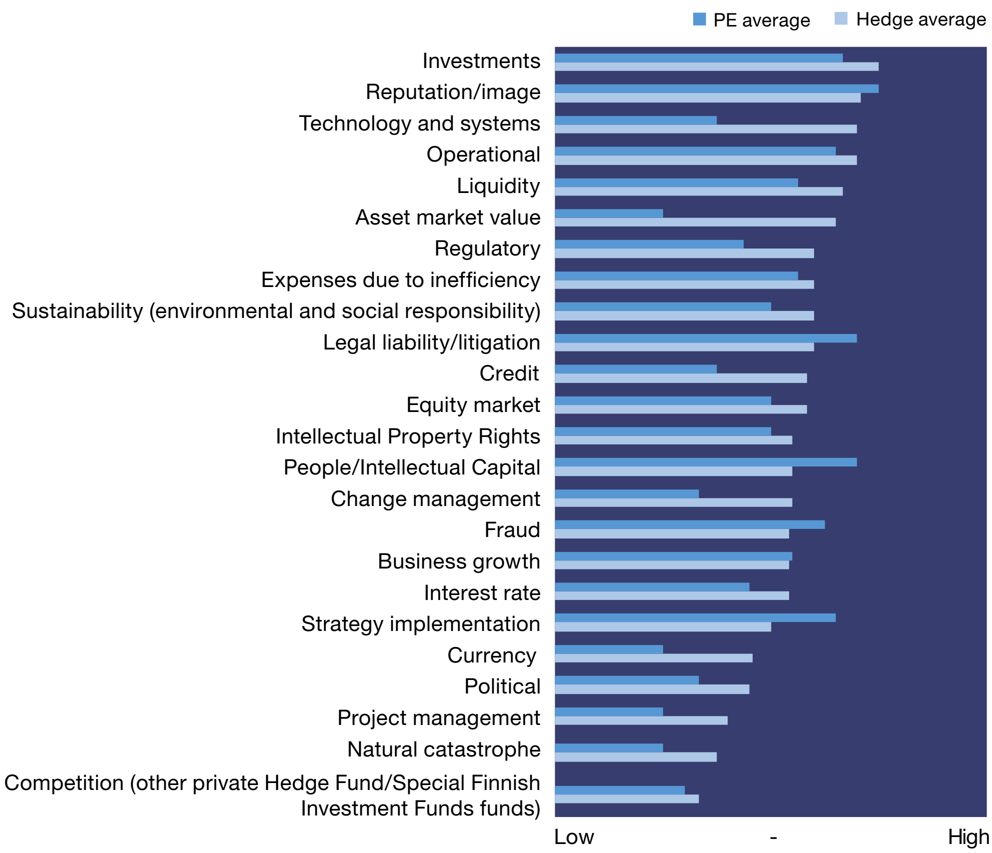
According to the survey, the typical risk categories used in PE firms related to:
- human resources
- the Limited Partnership agreements/structures
- investment phase

• geographical location of investments
• market of available good investment prospects / deal flow
• investment process in portfolio company
• managing the portfolio companies
• exits.

PE firms felt that the most important risk categories for their business are risks related to reputation and image, legal liability and litigation, people and intellectual capital, strategy implementation and fraud. Hedge fund providers, however, felt that the most important risks related to investments, reputation and image, operational issues, and technology and systems used.

Thus, it seems that PE firms see important risks and the need to tackle them in a wider perspective (firm level strategy, people, etc.) than hedge fund providers, who seem to be concerned mainly with fund operations (operational, systems, etc.), and financial and investment specific risks. An interesting outcome is that despite the different operating environments, both respondent groups rated reputation and image among the most important sources of risk.

Importance of risk source - Hedge Funds & Private Equity



The majority of respondents (from all groups) use consultants in various risk management areas, such as audit, or software technology and/or IT. PE firms also seem to use legal advisory, and consultants assessing business risks and environmental impact. However, only a few companies used consultants in the ERM process. This result was unusual as the demand in the market for improved risk management transparency is ever increasing from both the investor and the fund provider perspectives, and companies do not always have enough resources to conduct the ERM development projects themselves.

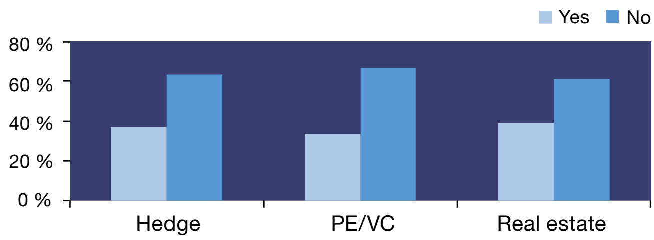
12 Governance and compliance of investors and fund providers

The views of investors concerning the client interest of fund managers

Investors were asked about their views on hedge fund managers compared with other fund managers and about half thought that hedge fund managers are more skilful than other fund managers.

Investors were also asked for their views on whether fund managers have high ethics and always put clients' interests first. Between 30 % and 40 % of those interviewed considered that fund managers did have high ethics and that they always put clients' interests first. On the other hand, the rest of the investors were of the opposite opinion.

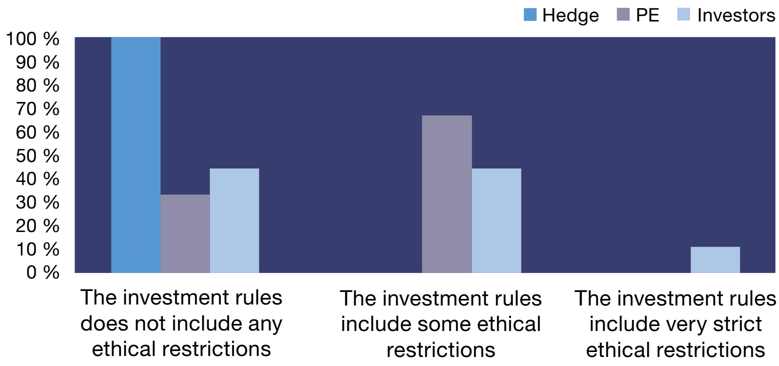
Do you believe hedge fund / private equity and venture capital / real estate fund managers have high ethics and always put client's interests first?



The importance of ethical questions among investors and fund providers

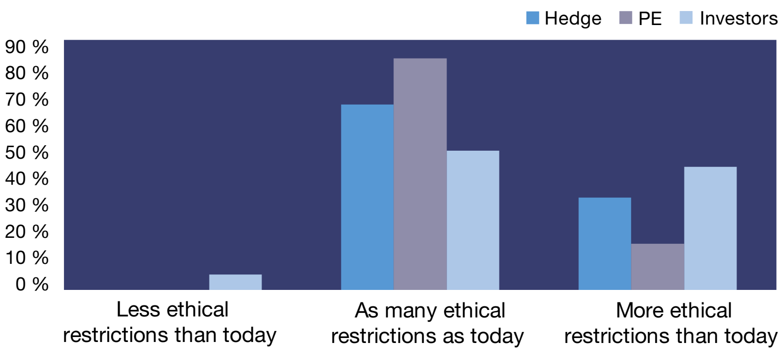
Investors and fund providers have to deal with different types of ethical questions. Investors carry out the ethical dimension of their investment policy either by involving these policies as part of their investment decisions or by writing these policies directly into their investment rules. The vast majority of investors do not include any ethical restrictions or include only some in their investment rules. Only a small minority of investors include very strict ethical rules. Based on the survey, hedge funds do not include any ethical restrictions in their investment rules and the majority of the PE funds include only some ethical restrictions.

Do you have clear ethical rules included in your investment rules?



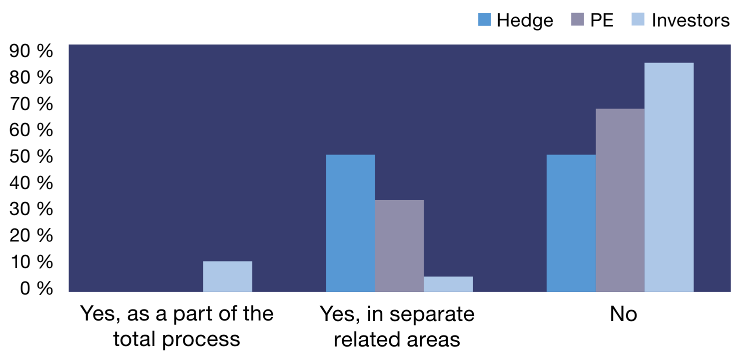
Ethical questions are being raised more frequently nowadays when discussing investment policies. A majority of both the investors and the fund providers assume that ethical restrictions will not increase during 2006–2008. On the other hand, a large number of both investors and fund providers are of the opinion that ethical restrictions will increase during 2006–2008.

Ethical based restrictions in investment policies during 2006-2008?



Ethical issues are an area of alternative investments that seem likely to have a strong influence on the investment policies of both investors and fund providers in the coming years. It is also an area where many fund providers are using advisors to assist them with their ethical questions. On the other hand only a small minority of investors use advisors to assist them in these ethical questions.

Use of advisors to assist with the ethical compliance?



13 Investors and fund providers and the regulator

Main challenges for investors coming from the regulators today

For those investors in Finland that are supervised by ISA, the single biggest challenge they face was identified as being the extensive regulatory reporting requirements set by ISA. The medium and smaller companies supervised by ISA especially feel that the quarterly regulatory reporting regulations are tailored for larger organisations; i.e. the reporting seems too extensive and is thus a lot less suitable for medium or smaller organisations. Investors also mentioned the strict and comprehensive solvency rules that do not always reflect the actual operating environment of the risk and the return profiles of the assets in which investors are investing.

For those investors in Finland, which are supervised by FIN-FSA, the single biggest challenge with the regulations was stated to be the extensive regulatory reporting requirements set by FIN-FSA. Investors of smaller sized companies supervised by FIN-FSA in particular felt that quarterly reporting regulations are far too extensive, expensive and are tailored for large organisations.

Today the special common funds, the non-UCITS, are not allowed to utilise borrowings. Most investors feel that special common funds should be allowed to utilise borrowings, as that is how foreign hedge funds operate. Only a minority of investors considers this issue to be irrelevant. Investors regulated by ISA feel that the present regulations limit investment management efficiency, and due to current regulations prevailing investment rules may be too strict in the case of asset classification and solvency margins.

From the regulator's perspective, there are distinctive differences between UCITS and non-UCITS funds in Finland that affect the granting of marketing authorisation by FIN-FSA. Whether the UCITS-directive is applied or not needs to be clearly stated in the fund's rules. It should also be clearly stated whether the fund's capital is variable and whether the products are intended for professional investors.

Additionally there are comprehensive consultation negotiations under way under IOSCO[7], where the Regulatory Environment for Hedge Funds is being discussed.

Main challenges for hedge funds coming from the regulators today

The main challenges that funds have with FIN-FSA include the strict demands on risk management procedures and the occasional lack of clarity over which kind of instruments are allowed. It was highlighted by some hedge funds that the regulatory framework in Finland should be changed to suit best market practices better, as in Ireland and Luxembourg.

Most of the fund providers that are offering special common funds (non-UCITS) are of the opinion that it should be possible to use leverage. Today, as borrowing is not allowed, several opportunities to increase profitability are lost. A majority of the hedge fund providers (60 %) feel that the local regulations are limiting the growth of alternative investments in Finland among both institutional and retail investors.

[7] *IOSCO, The International Organisation of Securities Commissions*

According to many fund providers, certain changes are needed in the prevailing legal environment to bolster the growth of the alternative investment industry in Finland. One aspect is a change of the legal framework to correspond to the best market practice in other countries such as Luxembourg. There should not be any tax realised when an investor changes between funds provided by the same fund provider. Furthermore, there should be fewer restrictions concerning credit derivatives. On the other hand, some fund providers do not see any need to make changes in the legal framework as the market is growing so fast anyway.

Main challenges for PE and VC funds coming from the regulators today

For PE companies one main regulatory challenge is dealing with the relatively time (and resource) consuming processes of the competition authorities both here in Finland and overseas, i.e. they may take a view that relations between companies should be thoroughly investigated. To a certain extent unclear personal liabilities and responsibilities of the Board were mentioned as regulatory problems in cases of official restructuring, or bankruptcy in Small and Medium-sized Enterprises (SME) where members of the Board may have personal liability for company taxes.

Some PE fund providers foresee that changes in the current legal environment of the alternative investment sector will have a positive impact on growth in Finland. Those changes may relate to taxation and limited partner structures in both Finland and other European countries.

14 Future challenges in the alternative investment area

The role of institutional investors in Finland in the future

Certain people as well as some institutions argue that institutional investors in Finland, especially the Finnish statutory pension companies, should increase their direct investments in both listed and non-listed domestic Finnish companies.

Some institutional investors are of the opinion that Finnish Institutional investors already have too much Finnish risk in their portfolio, and thus domestic direct investments should be underweighted and cross-border investments should be increased. Other arguments favouring underweighting in Finland are a better achievable country independent risk/return relationship, and abundant liquidity in the Helsinki Stock Exchange.

Other institutional investors are of the opinion that big Finnish institutional investors should increase the direct investments in both listed and non-listed Finnish companies. However the majority of investors are of the opinion that big institutional investors should increase their investments in non-listed Finnish companies in particular. The opinion of how investments should be allocated between listed and non-listed, and between different geographical regions varies significantly.

Some investors are of the opinion that there are both enough investment opportunities and investment capacity in Finland, while some investors are of the opinion that there are not enough attractive VC opportunities in Finland.

For the alternative investment sector in Finland, a major challenge seems to be to direct even more investment resources towards non-listed companies. This requires there to be a greater number of attractive investment opportunities in the VC area, and more investment allocations in non-listed companies by asset managers.

In the future a new directive, the Markets in Financial Instruments Directive (MiFiD), will influence the investment industry in Europe. The main objective of the new regulation is to provide better protection for investors, and it will influence many parts of the investment industry such as asset managers.

15 About PricewaterhouseCoopers

PricewaterhouseCoopers is a recognised leader in serving both traditional and alternative investment management products. Our Alternative Investments group provides clients with:

- A unique combination of coordinated accounting, tax and advisory expertise;
- Tax and business expertise (domestically and internationally) on the tax planning and structuring issues associated with alternative investment strategies and products;
- Industry knowledge to allow you to benchmark your practices against others in the industry; and
- Established relationships with the major participants in the marketplace.

PricewaterhouseCoopers is committed to helping our clients determine what successful firms will need to do to stay at the forefront in an increasingly competitive and dynamic industry. We set the pace in providing best practice and benchmarking information for leaders in the alternative investments industry through our seminars, special studies and thought leadership that all examine key industry trends. Our goal is to serve as a catalyst for ideas and provide insights from various perspectives in areas of interest to you. A select list of resources relevant to private investment funds and their sponsors includes:

- Our Annual Alternative Investments Seminar: Accounting, Tax and Regulatory Developments. Through our annual seminar, PricewaterhouseCoopers seeks to raise awareness of, and provoke timely discussion on the key trends, challenges and issues which impact alternative investment managers.
- CFO Roundtable Series—Private Equity and Hedge Funds: A periodic roundtable to allow senior finance/administrative personnel to discuss key industry issues.
- PwC Alternatives: A quarterly publication, which provides insightful, thought provoking articles on topics affecting the hedge fund and private equity fund communities.
- Private Investment Funds—Under the Microscope: Our industry monographs focused on new challenges and scrutiny facing the industry.
- Money Tree™ Survey: The venture capital industry's premier survey and barometer of investment activity.
- Nextwave™: A newsletter that provides ideas for private equity investors and entrepreneurs in the technology industry.
- Venture Capital Best Practices™: A survey series that reflects the practices, policies and views of US venture capital firms.

The foundation of many of our client relationships includes independent audits and pro-active global tax services. The advisory services we offer the industry, however, range well beyond these cornerstones, and they include:

- Regulatory Compliance Consulting
- Product Structuring
- Transaction Services/Due Diligence
- Operational and Systems Advisory Services
- Risk Management Services
- Investment Performance Measurement.

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