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HEDGE FUNDS IN GERMANY: NEW DEVELOPMENTS

Earlier this month, the German Finance Minister announced plans to allow hedge funds to be sold in Germany as of 2004, which would constitute a fundamental change in German capital markets. Experts say this change could bring up to €50 billion into Germany's capital markets in the next three years. This proposed change is in line with recent developments around the world to enable retail investors to access alternative investment products in an environment where traditional retail funds have followed equity markets on their downward spiral in contrast to gains generated by absolute return funds, largely denied to the retail punter through local selling restrictions.

Indeed, this move coincides with the publication of IOSCO's report on regulatory and investor protection issues arising from participation by retail investors in (funds of) hedge funds.

Highly Regulated Environment

Under the regulatory regime in Germany, the sale and distribution of foreign and domestic funds is highly regulated. In general, there are different sets of rules for foreign (offshore) funds and domestic (onshore) funds. For its shares to be promoted in Germany, a fund needs to be licensed by the German regulatory authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, "BaFin"). In addition, any public distribution of securities (including interests in funds) requires the publication of a sales prospectus.

The German regulator has created a particularly unfriendly environment for alternative investment vehicles and hedge funds by imposing two basic restrictions on funds offered for sale in Germany:-

- They may not borrow against their assets, so that fund managers cannot utilise leverage.
- They may not sell short. Fund managers cannot therefore utilise a short selling (*Leerverkäufe*) strategy within a fund. Hedge funds have long been the centre of controversy with regard to short selling, with many claiming that their activities contribute to market volatility.

Without the ability to utilise leverage or sell short, two fundamental distinguishing features of hedge funds, funds offered in Germany have not been able to generate superior returns nor have they been able to compete effectively in the German market place. In addition, Germany imposes a prohibitive level of tax on income deriving from hedge funds. Income derived from either onshore funds or offshore funds which are registered with the BaFin (so called "white" offshore funds) is taxable to a limited extent at the level of the individual shareholder. Distributions and accumulated profits deriving from interest and dividends are subject to income tax, but there is no taxation of capital gains. On the other hand, investments in offshore funds which are not registered with the BaFin and do not have a German representative (so

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called “black” offshore funds) are, in addition to the taxation of any distributions to shareholders, subject to further income tax at the rate of at least 10% of the value of the shareholder’s interest at the end of a calendar year or 90% of the increase in value of the interest in the fund over that year, if higher. As a result, the investor in a black fund – such as hedge funds – will have to pay taxes even if his investment in the fund has generated losses in the assessment period.

Currently, the only way around these hurdles is by the issuance to German investors of hedge fund certificates, and several banks have issued these in recent years. They are designed to provide investors, mostly institutional investors and wealthy individuals, with access to a range of underlying hedge funds. The certificates are usually linked to hedge fund indices (e.g., the S&P Hedge Funds Index). However, due to higher management and bank fees, these certificates have never generated the same returns as direct hedge fund investments.

Proposed New German Hedge Fund Rules

In order to strengthen Germany’s competitiveness as a financial centre, the government plans to overhaul the country’s investment fund and tax laws. As a first step, the proposed legislation will allow hedge funds (onshore and offshore) to be sold in Germany starting in 2004. As the exposure of German institutions to hedge funds is currently still low compared to their American, British and Japanese counterparts, this initiative is targeted to attract hedge fund managers to Germany through the proposed liberalised regulatory regime.

The Finance Minister has announced major changes to be implemented by the Investment Act 2003 (*Investmentgesetz 2003*) which is intended to consolidate all major legal requirements for hedge funds which are currently housed in a variety of legislative measures. However, since publication by the Federal Ministry of Finance (*Bundesministerium der Finanzen*) of the first draft of the Investment Act 2003 will not be before the end of May 2003, the details of the new regulations are not known. The major changes already announced are:-

- Efficient regulatory supervision of investment funds. Hedge funds will require prior authorisation by the BaFin. The general registration process for funds will be substantially shortened. It seems likely that the current requirement – that offshore funds will have to nominate a deposit bank and a bank as payment agent in Germany – will remain in place.
- Increased transparency for investors with a focus on basic information about a fund and the fees associated with it. There will be a streamlined sales prospectus (*Vereinfachter Verkaufsprospekt*) allowing investors to receive all essential information about an investment fund at one glance.
- There will be a unified regulatory basis for the sale and distribution of onshore and offshore hedge funds, which will allow for their direct sale in Germany. This will make the sale of complex financial products such as hedge fund certificates unnecessary.
- Hedge funds will be allowed to use the techniques of leverage and short selling. However, in order to increase market transparency, the fund manager may be required to notify the BaFin of short sales within a specified notice period.
- Private investors will only be permitted to invest in funds of hedge funds (*Dachfonds*), which ensure a broad risk diversification, and not directly in hedge fund themselves. The protection of private investors is one of the main objectives of the new laws. However, a clear definition of “private investors” remains one of the details to be resolved by the proposed regulations. It is likely that the definition may cover persons dealing with securities on a non-professional and non-commercial basis (i.e., retail consumers).
- Each sales prospectus must include a clear warning that there is a substantial risk of the total loss of an investment. Such warnings are

also required, for example, under the Swiss law.

- The government intends to enact a new German Investment Tax Act (*Investmentsteuergesetz*) regulating the taxation of investment funds, which is scheduled to come into force on 1 January 2004. However, as this new Act requires the approval of the German Federal Chamber (*Bundesrat*), the outcome of this legislative project is very difficult to predict. Basically, the taxation of hedge funds is proposed to be equivalent to the taxation of other conventional funds, removing the tax disadvantage associated with hedge funds discussed above. However, this is in flux as the future tax treatment of onshore retail funds is also under review because the government intends to abolish the tax exemption for distributions deriving from capital gains made by a fund itself. Therefore, the intention to harmonise the tax position of onshore and offshore funds could mean harmonisation on a higher tax basis.

These measures constitute part of a larger financial markets promotion plan (*Finanzmarktförderplan 2006*) put forward by the German government to strengthen the rights of retail investors and to implement UCITS III.

Overview

As indicated in our introduction, there is increasing pressure to bring hedge funds more into the mainstream and to create a regulatory environment in which an individual's investment portfolio can include an alternative

investment component. New retail regimes for the establishment and promotion of (funds of) hedge funds have been promulgated recently in Ireland, Singapore, Hong Kong and in the UK. The FSA has tested the temperature for a retail hedge fund product in its hedge fund discussion paper. It will report further at the end of the month.

The German developments will be watched closely. Unlocking the investment potential there could well spur liberalisation elsewhere.

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