WILMER CUTLER PICKERING HALE AND DORR LLP

EU Financial Services Group Briefing

20 SEPTEMBER 2004

Hedge Funds in Germany - First Experiences and Recent Developments

The German Parliament adopted a revised version of the new Investment Act 2003 nearly a year ago. Since then, the first hedge funds have been established in Germany. Up to September 2004, five funds of hedge funds (*Dach-Hedgefonds*) and two single hedge funds have been established. Six new products are currently under review by the German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, the "BaFin"). However, notwithstanding the efforts of the Government to open the market, foreign investment funds, in particular, have been reluctant to establish or promote a fund in Germany because of the high standards of regulation.

A further step has therefore been taken to increase demand for alternative investment products by institutional investors in the shape of the new Regulation on Investment for Insurance Companies[1]. The German Federal Ministry of Finance has amended the law and the BaFin has recently made comments to the new Regulation and established further requirements.

New Guidelines for Investments for Insurance Companies

Insurance Companies are subject to a strict regulatory regime regarding assets under management (*Gebundenes Vermögen und Sicherungsvermögen*) whose investment must follow the principles of:

- Security;
- Profitability; and
- Liquidity.

The German Federal Ministry of Finance is authorized to prescribe detailed guidelines for the permissible scope of investments of Insurance Companies, and has done so through the Regulation which is designed to protect the interests of insureds and specifies the types, percentages, and risk classes of assets an insurance company is authorized to invest in.

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1 *Verordnung über die Anlage des gebundenen Vermögens von Versicherungsunternehmen , AnlV* (the "Regulation") , issued by the German Ministry of Finance on 12 August 2004.

The previous Regulation did not specifically allow investment in alternative investment products. Based on the modifications in the new Regulation, the categories of authorized asset types has been widened and now specifically allows investment in alternative investment products as follows:

a) Domestic single hedge funds and funds of hedge funds now are authorized assets for investment, regardless of whether they are set up by investment companies (*Kapitalanlagegesellschaften*) or organized as investment stock corporations with variable registered capital (*Investmentaktiengesellschaften mit veränderlichem Kapital*).

b) Additionally, insurance companies also can invest in foreign hedge funds provided that (i) the issuer of the shares in these funds has its seat in the European Economic Area; (ii) the foreign investment fund is subject to governmental supervision that grants an equal level of protection for the insurance company as available in Germany; and (iii) the insurance company can request redemption of its shares in the funds at their actual market price.

Direct or indirect investments in such hedge fund products (collectively "Hedge Funds") are subject to certain thresholds and limitations. In particular, these are as follows:

- Investments in Hedge Funds are generally restricted to 5% of the assets under management.

- Insurance companies may not invest more than 1% of their assets under management in one and the same single Hedge Fund. Furthermore, they may not invest in more than two single Hedge Funds launched by one and the same manager. Finally, insurance companies may not invest in single Hedge Funds that invest more than 50% of their assets in funds (Hedge Funds or other) themselves.

- Insurance companies may invest up to 5% of their assets under management in funds of Hedge Funds, which must ensure broad risk diversification.

Requirements of the Investment Process and Risk Management

Due to the fact that Hedge Funds are viewed as particularly risky investments, and insurance companies have to safeguard their clients' funds, the BaFin guidelines provide recommendations for insurance companies' investment in Hedge Funds. Such guidelines relate to:

- Appropriate personnel;

- Investment process and due diligence; and

- Risk management.

It is expected that all insurance companies will follow these guidelines and Hedge Funds providers, which target the insurance companies, are well-advised to structure their products to accommodate these requirements.

Appropriate Personnel. BaFin's guidelines are as follows:

- Insurance companies may only invest in Hedge Funds when they have qualified personnel that have sufficient knowledge of specific hedge fund-related risks. In particular, the responsible persons of the insurance company concerned must have substantial knowledge of risk management in derivative financial instruments.

- Insurance companies must establish internal guidelines for investment in Hedge Funds (i.e. approval matrix, risk management systems) and draw up lists of the personnel responsible for Hedge Funds investments.

Investment Process and Due Diligence. Regarding the investment process BaFin requires due diligence to be performed by the insurance company. BaFin has established minimum requirements for the information that have to be obtained before making the investment:[2]

- Information on the structure of the fund and its organization, management, investment strategy, risk management, and depository bank;

- Restrictions on investment and anticipated liquidity of the fund;

- Scope of leverage and extent to which the fund may make short sales;

- Last annual and semi-annual reporting; and

- Terms and conditions, articles, and prospectuses.

In addition, the following information should be requested as part of due diligence:

- Type of investments the fund will make;

- Information regarding the fund managers, key personnel, and outside service providers;

- Investment guidelines and process; and

- Liquidity and possibility to withdraw from the investment.

The Federal Association for Alternative Investments (*Bundesverband Alternative Investments e.V.*) and BaFin have developed a sample questionnaire for such due diligence. The insurance company is obliged to document their due diligence.

Risk Management and Continuous Monitoring. Under the guidelines proposed by BaFin, the insurance companies have to ensure continuous monitoring of their Hedge Fund investments. In particular, the insurance companies must monitor the compliance of the funds managers with their investment strategies. They must request the delivery of risk allocations. In case of investment in single hedge funds, the insurance company shall frequently request a confirmation of the depositary bank of the value of the funds under investment.

BaFin permits the outsourcing of such risk management and monitoring functions to appropriate service providers. The funds' depositary bank or any of its affiliates cannot be appointed.

Monitoring by BaFin

Furthermore, the BaFin has established new reporting requirements for insurance companies. On a quarterly basis, insurance companies must – besides other reporting requirements – report every new investment in Hedge Funds and must provide a detailed description of the investment.

Conclusion

Furthermore, the BaFin has established new reporting requirements for insurance companies. On a quarterly basis, insurance companies must – besides other reporting requirements – report every new investment in Hedge Funds and must provide a detailed description of the investment. The revised Regulation opens a new market for Hedge Funds in Germany as insurance companies may for the first time invest both in single hedge funds and funds of hedge funds. This represents the next step of the German government to strengthen the German marketplace for alternative investment products. However, Hedge Funds must comply with the principles established for investment by insurance companies such as security, profitability, and liquidity. Therefore, to some extent, fund products will have to be tailor-made for this market segment.

[2] In the case of funds of hedge funds, the following information must only relate to the fund of hedge funds itself, but not to each target fund held by it.

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