WILMER, CUTLER & PICKERING

# EU Financial Services Group Briefing

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## Hedge Funds in Germany: New Opportunities for Domestic and Foreign Managers and Promoters

Following its announcements in March 2003 the German Federal Ministry of Finance (*Bundesfinanzministerium*) published on 8th July the first drafts of the Investment Act 2003 (the "Investment Act") and the Investment Tax Act (the "Investment Tax Act"). The government expects the new law to come into force on 1st January next year.

### MAIN OBJECTIVES OF THE INVESTMENT ACT

The Investment Act is designed to strengthen Germany's competitiveness as a financial centre. The main objectives of the new legislation are to:

- create a flexible regulatory environment for the sale of existing or developing financial products;
- accelerate filing, registration, and notification proceedings;
- improve the effectiveness of supervision by the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, "BaFin");
- strengthen the protection of private and institutional investors; and
- increase market transparency, in particular regarding trading methods and costs.

To achieve these objectives, the Investment Act creates a new, unified regulatory basis for the establishment and distribution of onshore and offshore funds in Germany. Regarding the sale and distribution of Hedge Funds, the Investment Act differentiates in general between:

- ***Investment Funds*** (*Sondervermögen*)
  This includes any funds managed for the benefit of investors subject to their terms and conditions.
- ***Special Investment Funds*** with additional risks (*Spezial-Sondervermögen mit zusätzlichen Risiken*, "Hedge Funds")
  Funds which by their terms and conditions allow their managers to use either leverage or short selling as investment techniques are deemed to be Hedge Funds.

- ***Funds of Hedge Funds*** (*Dach-Sondervermögen mit zusätzlichen Risiken)*
  These are defined as funds which invest their investment capital in foreign or domestic Hedge Funds ("Target Funds") or—subject to further restrictions (see below)—other Funds of Hedge Funds.

The distribution of Special Investment Funds requires the prior publication of both a detailed and a streamlined (short form) sales prospectus (*Vereinfachter Verkaufsprospekt*). The purpose of the streamlined prospectus is to provide investors with information material to the investment decision in a short, clear, and comprehensible way.

The details of the new Hedge Fund rules are as follows:-

### HEDGE FUNDS

As long as it is classified as a Hedge Fund under the law the fund may follow traditional strategies such as event-driven, long/short, fixed income, etc., as well as newly developed strategies.

Besides the general rules applying to all investment funds, there are additional restrictions for Hedge Funds:-

- Shares in Hedge Funds may only be sold to a group of not more than 30 investors who are not natural persons (*i.e.* companies, corporations, other investment funds etc.).
- Shares in Hedge Funds not established under German law ("Foreign Hedge Funds") may not be publicly distributed within Germany. This

restriction applies to all Foreign Hedge Funds even if they or their manager or promoters have their principal place of business within the EU or the European Economic Area ("EEA"). This does not prohibit a private placement of such funds, provided it is done in compliance with the existing laws. Please note, however, that a "private" transaction is still not defined under German law, and the BaFin applies very narrow criteria to determine the private nature of a sale.

- A Hedge Fund may not invest more than 30 percent of its assets in companies not listed on a stock exchange. Therefore, private equity funds are not treated as Hedge Funds under the proposed legislation.
- Hedge Funds may not invest in commodities.

There is no prescribed minimum amount to be invested into Hedge Funds.

**FUNDS OF HEDGE FUNDS**

In contrast to Hedge Funds, Funds of Hedge Funds based in the EU or EEA *may* be publicly distributed to an unlimited group of both *private* and institutional investors. The public distribution of Funds of Hedge Funds based outside the EU and EEA is prohibited unless the Federal Ministry of Finance establishes by regulation special exemptions for certain non-EU and non-EEA jurisdictions such as the US or Switzerland. Such exemption will only be made if (i) the foreign jurisdiction allows German funds to be sold, (ii) the respective jurisdiction provides sufficient standards of regulation, in particular regarding investor protection, (iii) the respective foreign supervisory authorities cooperate with BaFin, (iv) the respective foreign fiscal or tax authorities cooperate with the German Federal Financial Office, and (v) the cooperation of the aforementioned institutions is based on intergovernmental treaties. Therefore, it seems unlikely that Funds of Hedge Funds managed in *e.g.* the Cayman Islands will be admitted for public distribution in Germany. These restrictions, however, have already been criticized and are still under discussion. Nonetheless, Funds of Hedge Funds may still invest in non-EU and/or non-EEA Hedge Funds.

The draft law does not provide any threshold as to the minimum amount to be invested. In order to ensure broad risk diversification and to protect private investors from a total loss of their investment, Funds of Hedge Funds may not invest:

- more than 49 percent of their capital in cash in banks or in money market instruments;
- more than 20 percent of their capital in any one Target Fund;
- more than 40 percent of their capital in Target Funds which have the same investment strategy;
- in more than two Target Funds launched by one and the same manager; or
- in Funds of Hedge Funds, except where the Target Fund does not invest more than 30 percent of its assets in other Target Funds itself.

Managers of Funds of Hedge Funds must ensure that they have unlimited access to all material data regarding the Target Fund's investment, to ensure compliance with the thresholds listed above. In particular, they must be informed, among other things, of the Target Fund's annual and half-year reports, terms and conditions, sales prospectus, organization, administrative management, investment policy, risk management system, depository bank, investment restrictions, liquidity, and the extent to which the Target Funds use leverage finance and/or short selling. Further, the Target Funds must be supervised as to their compliance with their respective investment strategies. Therefore, managers of Funds of Hedge Funds must ensure that each Target Fund submits a weekly risk ratio report to them together with a confirmation of the value of the Target Fund's assets produced by the depository bank or administrator.

**Special Requirements Regarding the Prospectuses of Funds of Hedge Funds**

In addition to the general fund disclosure requirements, Funds of Hedge Funds must incorporate the following information in their prospectus or offering memorandum:-

- The principles under which the Target Funds are selected.
- The extent to which the fund may invest in foreign or unregulated domestic Target Funds.
- The requirements the managers of the Target Funds have to fulfill.
- The extent to which the Target Funds may use leverage and/or short selling together with a description of the associated risks.
- The cost structure of the Target Funds and the respective fee calculation methods together with information as to how the costs differ (if at all) in comparison with ordinary funds.
- Details of the conditions under which the investor may redeem his shares and, if relevant, a disclosure that the investor does not have the right to redeem his shares at any time.

In contrast to other investment funds, Funds of Hedge Funds do not have to prepare a streamlined prospectus in addition to the detailed prospectus. There must be a warning that investing in Funds of Hedge Funds may result in the total loss of invested capital.

**Special Terms and Conditions for Funds of Hedge Funds**

The terms and conditions of Funds of Hedge Funds must contain the following special provisions:

- Self-imposed restrictions as to the principles under which the Target Funds are selected, in particular, regarding the investment strategy followed by the Target Funds.
- Self-imposed restrictions as to the extent to which the Target Funds are allowed to use leverage and/or short selling together with a description of the risks connected herewith.
- Self-imposed restrictions as to the extent to which the fund may invest into foreign or unregulated domestic Target Funds.
- The amount up to which the fund may invest in cash in banks and/or money market instruments.
- All requirements and conditions under which the investor may redeem his shares.

Funds of Hedge Funds must not invest more than 30 percent of their capital in companies not listed on a stock exchange.

**Special Requirements for the Public Distribution of EU- and EEA-based Funds of Hedge Funds in Germany**

Prior to any public distribution of shares in Funds of Hedge Funds based in the EU or EEA within Germany, each fund has to comply with certain registration and notification requirements. The BaFin must be notified and public distribution may not take place unless either (i) the BaFin has granted approval, or (ii) three months have passed after notification without the BaFin having prohibited the sale. The manager has to submit—among others—the following documents in German together with a German translation (if applicable) to the BaFin:

- All material information regarding the fund itself, and its representative, as well as its administrator, distributor, depository bank/custodian and paying agent.
- Confirmations from the representative, depository bank/custodian and paying agent as to the performance of their respective functions.
- The fund's statutory documents and offering memorandum/prospectus as well as the updated sales prospectus.
- The latest audited financial reports and balance sheets.
- A declaration to abide by ongoing reporting vis-à-vis the BaFin.

**TAX ISSUES**

Under the Investment Tax Act, taxation rules for German investment funds and for foreign investment funds, currently governed in separate laws, will not only be merged into one single code but will also be unified to a large extent. There will no longer be a treatment of foreign funds as "white," "grey" or "black" funds with different tax consequences (discussed in our March 2003 Newsletter "*Hedge Funds in Germany: New Developments*"). Instead, the issue of whether an investor in a German or foreign fund can profit from a relatively advantageous taxation system (or "regular taxation"), or will face prohibitive taxation, now depends on the transparency of the fund as determined by the BaFin regarding the components of the fund's distributions and deemed distributions.

**Scope of the Investment Tax Act**

Regarding the taxation of Hedge Funds and Funds of Hedge Funds, it has to be stressed that the new tax code will not apply to all Foreign Hedge Funds. While the code will apply to all German funds (including Hedge Funds), foreign funds will only be subject to, and benefit from, the code if:

- they are subject to the laws of an EU or EEA member state and are subject to the respective investment funds supervision provisions; or
- they are approved for public distribution in Germany or listed on a German stock exchange.

**Regular Taxation and Prohibitive Taxation**

Regular taxation rules will apply to German and foreign funds if the fund makes available to the investor with each distribution (or no later than four months after a deemed distribution) certain information such as: the amount of the distribution and/or deemed distribution; and all relevant components of the distribution or deemed distribution, like capital gains from the sale of securities, dividends, income from foreign sources and tax credits. The fund has to publish this information in the electronic Federal Gazette (*elektronischer Bundesanzeiger*) and is obliged to verify the published information on the request of the BaFin. In the case of a Fund of Hedge Funds, the draft code does not explicitly state whether or not the information requirements also refer to all Target Funds. However, most experts assume that this will be the case. Therefore, it can be assumed that many of the Funds of Hedge Funds may have difficulties in providing sufficient information to benefit from the regular taxation regime.

If a fund meets these requirements, its investors will be able to make use of a favourable tax relief (the so called: *Halbeinkünfteverfahren*) in the case of individuals, or of the general tax exemption in the case of corporate investors, and in each case with regard to fund distributions or deemed distributions resulting from dividends or from capital gains in corporate stock. Moreover, capital gains from the fund's derivative transactions will be tax exempt. The same will apply to capital gains from real estate held by the fund for at least 10 years.

If a fund does not meet these information requirements, the taxation regime will be similar to some of the rules that currently apply to "black" offshore funds (i.e. the prohibitive tax regime): the investor will not only be obliged to pay tax on the distributions and deemed distributions of the fund, but he will also have to pay annual income or corporation tax on 70 percent of the increase in value of his interest in the fund and at least (as a minimum tax) on the basis of seven percent of the value of the interest in the fund at the end of each calendar year (even if the value did not increase during the respective year).

### Additional Changes Regarding Taxation

There are certain other changes in the treatment of Foreign Hedge Funds which generally ensure equal treatment with onshore Hedge Funds:

- ***Representative for tax purpose***
  The applicability of the regular taxation regime for foreign funds will no longer depend on the existence of a German representative of the foreign fund for tax purposes.

- ***Computation of profits***
  Both German and foreign funds will be obliged to compute their respective profits generally on a cash flow basis: liability reserves, for example, will not have any influence on the computed profits. This requirement might lead to additional costs for foreign funds that are used to drawing up a balance sheet at the end of each business year.

- ***Withholding tax***
  Both German and foreign funds will be subject to the same withholding tax requirements. This will be a slight aggravation for German funds while foreign funds will have to deal with lower withholding requirements than under the current tax regime. For example, profits of foreign funds deriving from dividends shall no longer be subject to withholding tax.

## CONCLUSION

### German Managers and Promoters

No longer will German managers and other financial institutions be forced to circumvent Germany's unfavourable fund tax laws by creating hedge fund certificates—they can establish the real thing: single hedge funds for their institutional clients and funds of funds for the retail market.

### Foreign Managers and Promoters

The opportunities these proposals present to foreign hedge fund managers will depend on whether they manage EU/EEA funds of hedge funds or not. As the only single hedge funds that can be offered other than on a private placement basis are German funds, those established in any of the offshore jurisdictions or onshore in Italy or Switzerland, for example, will not qualify. However, managers of EU or EEA funds of hedge funds will now, subject to BaFin approval, be able to distribute their funds to the institutional and retail markets subject to the compliance monitoring (e.g.weekly reporting) and tax information requirements described above. That does represent an opportunity to funds of hedge funds set up under the new Irish and Luxembourg laws, for example.

The position is made difficult for non-EU or non-EEA funds of hedge funds given the thresholds for public distribution described above. It may be possible for fund of hedge fund managers to access the German market by establishing a German fund of hedge funds, with their existing portfolio of funds as Target Funds, but again the reporting and other requirements may prove unduly burdensome.

Another solution would be to set up stand alone funds from a German base, perhaps in tandem with a German partner.

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