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# EU Financial Services Group Briefing

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## Hedge Funds in Germany – German Parliament Opens the Market for Alternative Investment Products

On 28 November 2003 the German Parliament finally adopted a revised version of the new Investment Act 2003 (the “Investment Act”) and the Investment Tax Act 2003 (the “Investment Tax Act”) which will both come into force on 1 January 2004. With the new Investment Act and the Investment Tax Act the German Federal Ministry of Finance (*Bundesfinanzministerium*) made a step forward to implement its Financial Markets Promotion Plan 2006 (*Finanzmarktförderplan 2006*). For the first time the German market will be opened to onshore and offshore single manager hedge funds. Subject to certain compliance requirements, foreign hedge funds will be allowed to be sold on a private placement basis in Germany under conditions comparable to onshore funds

The new law is based on the draft legislation dated 8th July 2003<sup>1</sup> which was substantially amended through the legislative process. Here we outline the main changes and highlight those of the original provisions which have been kept. The law still differentiates between:

- **Investment Funds** (*Sondervermögen*)  
This includes any fund vehicles managed for the benefit of investors subject to their terms and conditions.
- **Investment Funds with Additional Risks** (*Sondervermögen mit zusätzlichen Risiken*, “Hedge Funds”)  
Funds which under their terms and conditions allow their managers to use leverage and/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 in foreign or domestic Hedge Funds (“Target Funds”) or – subject to further restrictions – other Funds of Hedge Funds.

The funds can be structured as separate funds of a German investment management company (*Kapitalanlagegesellschaft*) or as an investment stock corporation (*Investmentaktiengesellschaft*).

<sup>1</sup> For details of the hedge fund regulations as proposed at that time, see our EU Financial Services Group Briefing dated July 31, 2003.

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In the context of Hedge Fund regulation, it appears that the changes in the final version of the new law are intended to loosen the rather restrictive initial proposals and to provide more discretion to the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, "BaFin") to react to the actual developments and requirements of the markets, once the new laws are in effect. Certain questions will require immediate clarification by BaFin releases in order to create a stable investment environment for fund managers as well as for investors. The major changes in the new law are as follows:-

## **Hedge Funds**

- ***Target Investments***

Hedge Funds are allowed to allocate their capital in all kinds of investments such as securities, money market instruments, derivatives, cash in banks, funds (including offshore funds), passive partnership interests, equity interests, precious metals and cash settled commodity futures traded on a regulated market. Fund managers are granted wide flexibility subject to the following restrictions:-

- no investment in real estate or participations in real estate companies;
- investment in unlisted private equity is limited to a maximum of 30% of the fund's assets; and
- no investment in commodities (save as noted above).

- ***Distribution***

The initial draft Investment Act allowed Hedge Funds to be sold to up to 30 non-private investors. This explicit private placement "safe harbour" has now been dropped. Instead, the new law provides that Hedge Funds must not be "publicly" distributed. Public distribution means any distribution by way of a public announcement, public advertisements or similar marketing methods. This new definition brings some uncertainty as to whether or not an offering of Hedge Funds to investors may be prohibited. In other contexts the BaFin has taken a rather restrictive approach when defining "public

distribution". Sales may be deemed "public" even if a fund is sold to less than 30 investors. Therefore, although the change in the law does now allow private placement of Hedge Funds without imposing investor qualifications, the explicit prohibition of "public distribution" raises the risk of uncertainty for sales of Hedge Fund products by removing the previously proposed clear cut safe harbour. The day to day practice of the BaFin will shed more light on the actual thresholds. We expect a BaFin release clarifying this issue.

- ***Depository Banks***

Each investment management company and/or investment stock corporation has to appoint a bank to act as custodian and monitor of the fund's assets and the invested capital (the "Depository Bank") with the overriding duty to safeguard the investors. The appointment and any change of the Depository Bank require approval of the BaFin. The Depository Bank: collects subscriptions from investors and books them into a blocked account (*Sperrkonto*); pays investors who have redeemed their shares (if provided for in the fund's terms and conditions); and executes transactions as directed by the fund's manager. In order to protect the investors the Depository Bank has to check each investment for compliance with the statutes and the fund's terms and conditions. In addition, the Depository Bank may outsource some of its tasks to similar institutions (such as, e.g., prime brokers or administrators), provided that the Depository Bank remains liable for their misconduct.

- ***Prospectus Requirements***

Even though the new law does not permit public distribution of Hedge Funds, it appears that a sales prospectus and a short-form sales prospectus must nevertheless be prepared and made available for investors. The new law requires further clarification on this issue. It remains to be seen how the BaFin will handle these requirements in practice.

- ***Main Content of the Sales Prospectuses***

As a general rule the prospectus must provide the investor with information necessary and sufficient for him to make a decision to invest.

The law contains a rather comprehensive list of data and information to be disclosed in the prospectus. In contrast to the rules regarding Funds of Hedge Funds, however, there is no obligation to include a warning in the prospectus stating that any investments in Hedge Funds may result in a total loss of the invested capital.

## Funds of Hedge Funds

### • *Target Investments*

The section of the Investment Act regarding Funds of Hedge Funds was subject to only one major change: Funds of Hedge Funds may only invest in foreign funds (“Target Funds”) if the assets of these Target Funds are in the custody of a Depository Bank (or a “similar institution” as described above). Besides that the following thresholds apply: Funds of Hedge Funds may not invest:-

- more than 49% of their capital in cash in banks or in money market instruments;
- more than 20% of their capital in any one Target Fund;
- more than 40% 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% 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 investments to ensure compliance with the thresholds listed above. In particular, they must have the following information concerning the Target Fund: its annual and half-year reports, terms and conditions, sales prospectus, organisation and 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, each Target Fund must be monitored on its compliance with its investment strategy. Therefore managers of Funds of Hedge Funds must ensure that each Target Fund submits regular risk ratio reports<sup>2</sup> to them together with a confirmation of the value of the fund’s assets produced by the Depository Bank or administrator.

### • *Distribution*

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 BaFin 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 provides sufficient standards of regulation, in particular regarding investor protection, and; (ii) the respective foreign supervisory authorities cooperate with BaFin. Furthermore, the requirements of the EC-Directive 85/6M/EC have to be met. Therefore, it seems unlikely that Funds of Hedge Funds managed in *e.g.* the Cayman Islands will be admitted for public distribution in Germany. Nonetheless, Funds of Hedge Funds may still invest in non-EU and/or non-EEA Hedge Funds.

### • *Prospectus Requirements*

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

- 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;

<sup>2</sup> The *Bundesfinanzministerium* is entitled to issue a regulation to set forth the standards for appropriate risk measurements systems. The *Bundesfinanzministerium* can delegate the ruling to the BaFin.

- 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; and
- 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 short-form sales 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.

### **Taxation**

The initial draft Investment Tax Act provided for beneficial tax treatment of domestic and foreign funds (including Hedge Funds) if the requirements for so-called “regular taxation” were met (see below). However, the applicability of that favourable tax regime to foreign funds was to be limited after 2005 to EU/EEA funds or following approval for public distribution in Germany or listing on a German stock exchange. The new law does not contain any such limitation. As a consequence, the Investment Tax Act applies to all domestic and foreign funds, including Hedge Funds and Funds of Hedge Funds, from 2004.

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 4 months after a deemed distribution) certain information according to Section 5 of the Investment Tax Act, such as: the amount of the distribution and/or deemed distribution; and all relevant components of the distribution or deemed distribution, such as 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 at the request of the BaFin. In the case of a Fund of Hedge Funds, the 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 Funds of Hedge Funds may have difficulties in providing sufficient information to benefit from the regular taxation regime.

If a fund meets these requirements, it will be treated as transparent for tax purposes. Moreover, its investors will be able to make use of a favourable tax relief with regard to distributed profits of the fund deriving from dividends (the so called: *Halbeinkünfteverfahren*) in the case of individuals, or of the general tax exemption in the case of corporate investors. With regard to distributed profits of the fund deriving from capital gains in corporate stock, corporate investors will be allowed to benefit from the same favourable tax treatment, while private investors will be totally exempt from tax.

If a fund does not meet the requirements outlined above, however, investors will not benefit from the favourable tax regime. The taxation regime will then be similar to the former taxation of so called “black” funds, including taxation of 70% of the annual increase in value of the investor’s share in the fund or – in the absence of an increase in value – taxation of 6% of the current value of the investor’s share in the fund.

### **Enforcement/Penalties**

As a general issue, throughout the new law the provisions concerning investment thresholds and other requirements for funds in general, Hedge Funds and Funds of Hedge Funds have been reinforced. It has been made clear that funds may only invest within these limits. Correspondingly, the penalty and enforcement provisions (*Ordnungswidrigkeiten*) have been substantially revised, to make sure any violation of the rules results in a penalty. Therefore, we



expect significant scrutiny of these products by the BaFin in the initial phase of these new laws. It will settle once market standards and a firm BaFin policy have developed.

## Conclusion

The intention of the new laws is to open up the German market for alternative investment products and to a significant extent to create a level playing field for onshore and offshore investment vehicles. It remains to be seen how German institutional and private investors react to the new products, and how those products will be structured. One support measure is already on its way, as the Bundesfinanzministerium in cooperation with the BaFin is already preparing an amendment to the regulation regarding the investment limitations for insurance companies (*Anlageverordnung*). It is expected that insurance companies will be granted more discretion to invest in alternative investment products, in particular hedge funds may be defined as a distinct investment category, which will allow insurance companies to invest more freely. Germany has been one of the last great untapped markets for alternative investment funds, and first movers will want to ensure that their products match expectations and that the new

regulatory framework will be sufficiently flexible and pragmatic.

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