

Introduction and REGULATION OF HEDGE FUNDS

in Germany

by Angelo Lercara, LL.M. EuR., Dechert LLP

On January 1, 2004 the German Investment Act and the German Investment Tax Act were enacted as the major parts of the Investment Modernization Act. The Investment Act replaced the German Investment Companies Act (*Gesetz über Kapitalanlagegesellschaften*) that regulated domestic investment funds and investment companies and also the Foreign Investment Act (*Auslandinvestmentgesetz*) dealing with foreign investment funds. The tax provisions for domestic and foreign funds, which were spread over the Investment Companies Act and the Foreign Investment Act now form the separate German Investment Tax Act.

The essential aims of the modernisation of the investment rules in Germany were to implement EC directives 2001/107/EC and 2001/108/EC to improve the competitiveness of German investment funds in relation to the other EU member states and the introduction and regulation of hedge funds to the German financial marketplace. The amendments to the taxation of foreign funds resulted from threatened action by the European Commission. This article summarises the introduction and regulation of hedge funds in Germany, a topic which has provoked a large amount of public interest.

PREVIOUS RULES

The former German investment rules hindered the creation of hedge funds as such funds often use short selling and

leveraging techniques which were not permitted by the Investment Companies Act or the Foreign Investment Act. Consequently, neither domestic nor foreign hedge funds could be publicly distributed in Germany. The private placement of foreign funds was possible but such unregistered funds were subject to punitive taxation. The industry's solution was to offer hedge fund related products such as hedge fund index-linked certificates or profit participation certificates which lay outside the scope of investment law. Under the new rules the German legislator provides for two types of hedge funds: single hedge funds ("SHFs") and funds of hedge funds ("FoHFs").

Single hedge funds

SHFs under the Investment Act are investment funds which adhere to the principle of risk diversification, are

generally not restricted in their choice of investments and whose terms and conditions permit the use of leveraging and/or short selling techniques. The distribution of SHFs in Germany is only possible by private placement although potential investors may be private as well as institutional investors. In order to ensure a certain quality of advice for the protection of investors, the distribution of SHFs is only possible through licensed credit institutions or financial service providers.

Private placement

There is no clear definition of “public offering” and “private placement” under German law but the German regulator (Bundesanstalt für Finanzdienstleistungsaufsicht) (“BaFin”) has provided some guidance as to their meanings in its announcement of September 1999. Although it was drafted in order to explain the rules under the Sales Prospectus Act (*Verkaufsprospektgesetz*), the announcement can be used as guidance in relation to private placement of investment fund shares. The BaFin is expected to publish further guidance in the near future.

In the September 1999 announcement, “public offering” is defined as an offering for sale to an undefined number of people who are not yet known to the offeror. “Private placement” is defined as an offer made to a limited number of private and/or institutional investors who do not require the protection of a registered prospectus. Such a limited number of addressees exists if they are previously and individually known to the offeror and are selectively approached by the offeror on the basis of their individual characteristics. As a general rule, the BaFin considers a placement to be private only if all recipients of the offer, related marketing material or other forms of advertisement have an existing investment relationship with the offeror (which may be the issuer or an intermediary). Under the principles governing private placement in Germany shares may be issued to an investor who approaches a fund on a wholly unsolicited basis.

Investment restrictions

SHFs are only subject to the following investment restrictions:

- not more than 30% of the NAV can be invested in participations in unlisted companies;
- no investment in real estate or real estate companies; and
- no investment in commodities (except precious metals and commodities futures contract)

FUNDS OF HEDGE FUNDS (FOHFs)

Legislation provides that the appropriate vehicle for private investors is the FoHF. Units of FoHFs can be distributed to private investors and institutional investors either by private placement or public offering.

Investment restrictions

There are more restrictions on FoHFs owing to the fact that they are publicly marketable. These are:

- a German FoHF cannot make use of short selling or leveraging techniques but is permitted to make use of currency derivatives for currency hedging purposes;
- at least 51% of the assets of German FoHFs must be invested in SHFs (target funds);
- not more than 20% of the NAV can be invested in one fund, although it is permitted to acquire 100% of a target fund;
- up to 49% of the fund’s assets can be invested in bank deposits and money market instruments;
- FoHFs may not invest in more than two funds controlled by the same manager although they may be products of the same investment company; and
- they may not invest in other FoHFs

FoHFs investment managers must demonstrate sufficient knowledge and experience of investing in hedge funds. An already existing management company might have to

extend its licence and satisfy the BaFin that its staff have the required knowledge and experience.

The target funds of a FoHF need not be regulated but must be from a Financial Action Task Force (FATF) cooperative country. The FoHF must obtain all information necessary for it to make an investment decision. Minimum information requirements are set out in the Investment Act. These are:

- the latest annual and half yearly reports;
- the fund rules and prospectus (or equivalent documents);
- information on the structure and management of the fund e.g. investment policy, custodian bank;
- details of investment restrictions;
- information relating to liquidity; and
- details on the use of short selling or leveraging techniques.

The BaFin may request the production of documentation evidencing the above.

Further requirements

The German FoHF must instruct another institution to have custody of the assets of its investment funds. The custodian must have its registered office or a registered branch in Germany and the selection of the custodian is subject to approval by the BaFin which has the power to place conditions on the appointment and may require the fund to appoint a new custodian.

Some of the duties of the custodian may be delegated to a “comparable institution”, obviously an attempt by the legislator to introduce the concept of a prime broker. Prime brokerage is a new concept in Germany. The legislator was unable to incorporate it fully into the new legislation as this would have entailed major changes in the way investment business is done in Germany. Guidance has been published as to how the Ministry of Finance see the inclusion of a prime broker working in practice in the German investment market.

Prospectus

A FoHF requires a long form prospectus containing prescribed information including:

- the basis on which target funds are selected;
- the extent to which investments may be made in unregulated funds;
- the minimum requirements that the management of the target fund must fulfil;
- the extent to which the target fund makes use of short selling leveraging techniques;
- the fee structures of the target funds; and
- redemption procedures.

The prospectus must contain the following risk warning in bold type and in a prominent position:

Warning by the Federal Minister of Finance “Fund investors should carefully consider whether they are prepared and financially in a position to assume losses with respect to their fund investments up to a total loss of their invested capital”.

THE DISTRIBUTION OF FOREIGN HEDGE FUNDS IN GERMANY

Single hedge funds

As mentioned above, SHFs may only be distributed by way of a private placement to professional investors or a limited number of investors. They must only be offered by licensed credit or financial services institutions

Funds of hedge funds

Foreign FoHFs can be marketed by private placement or public offering. Public offering is only possible after notifying the BaFin of the intention to market the units in Germany and if, within three months, the fund does not received a negative response to the notification. The BaFin will not prohibit distribution if:

- the investment policy is comparable to the investment policy of a German FoHF;
- the foreign FoHF is subject to effective supervision in its country of origin;

- in BaFin's experience, the supervisory authorities of the home state are prepared to co-operate with it in a satisfactory manner;
- the foreign FoHF has nominated a domestic credit institution or a reliable and qualified person with its seat or place of residence in Germany as a representative;
- it has appointed as paying agent at least one German credit institution or German branch of a foreign credit institution;
- the assets of the foreign FoHF are held by a custodian; and
- at least quarterly redemptions are possible on a maximum notice period of 100 days.

The sales prospectus of a foreign FoHF, must be approved by the BaFin and must contain the warning notice set out above. Foreign FoHFs are subject to the same rules as German funds in particular in respect to the warning statement and disclosure requirements. The sales prospectus and the terms and conditions must be in the German language.

TAXATION PRINCIPLES

Contrary to the old regime investors in domestic and foreign funds are now subject to the same rules and are taxed upon the principle of transparency. This means that the investors are treated as if they invested directly in the fund's assets. The fund itself is not subject to income or corporation tax in Germany. The fund can be "transparent" or "intransparent" under the new rules. The basic rule is: the more German tax information a foreign fund provides and publishes, the better the tax treatment for German investors.

In order to qualify as transparent the fund must fulfil a number of requirements. It must calculate certain tax figures upon distribution/accumulation and publish them in Germany with a certificate from a tax adviser (or other qualified person), stating that the published tax

figures were calculated in accordance with German tax law. If requested, a foreign fund must give proof to the German tax authorities within three months that the figures are correct. A transparent fund must also calculate the accumulated deemed distribution income and publish this figure and the redemption price.

If the fund only fulfils certain but not all of the information requirements, it is treated as "semi-transparent". The investors in such funds lose the tax benefits on those income components for which full disclosure has not been given.

If the fund fulfils none of the requirements it could be considered as "intransparent". In this case income distributed in relation to the investment units and 70% of the positive difference between the first and last redemption prices of the fund units in the calendar year will be attributed to the German investor as taxable income. At least 6% of the last redemption price of the calendar year will be attributed.

A FoHF can only achieve favourable tax treatment for its investors if it is able to obtain the above mentioned information from all its target funds. If a target fund is not able to furnish this information the investors of the FoHF will be subject to unfavourable tax treatment on the income derived from that target fund.



Angelo Lercara, LL.M. EuR. is a Lawyer at Dechert LLP in Munich.

**For further information, please
telephone +49 (89) 2121 6322 or
e-mail: angelo.lercara@dechert.com**