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This article examines whether investments of restricted assets of German insurance undertakings in UCITS III funds that employ hedge fund strategies count against the hedge funds quota of the Investment Ordinance.

Insurance Regulatory Framework and Statement of Problem

German insurance undertakings must invest their guarantee assets and other restricted assets in a way that ensures a maximum of security and profitability while maintaining liquidity and an adequate diversification and spread (§ 54 of the Act on the Supervision of Insurance Undertakings (*Versicherungsaufsichtsgesetz – VAG*)).

For primary insurance undertakings the Investment Ordinance¹ issued on the basis of § 54 VAG determines the eligible assets. It further covers quantitative diversification and spread-limits, regulations on congruency and situs of assets and commits insurance undertakings to a qualitative capital management and to internal control practices.

The Investment Ordinance limits investments in single hedge funds and funds of hedge funds to a maximum of five per cent of the guarantee assets and other restricted assets. This limit applies cumulatively to direct investments and indirect investments by way of structured products or special funds (so-called “hedge funds quota”).

Against the background of an increasing market share of alternative UCITS funds (so-called “Newcits”), i.e., UCITS III funds implementing alternative strategies and particularly typical hedge fund strategies, numerous regulated investors that are already active in the alternative investment segment and therefore utilize the hedge funds quota to a high degree, face an uncertainty if hedge funds within the UCITS III framework are to be counted against the hedge funds quota as well and, if this is not the case, against which other quota they should be counted instead.

Explicit regulations are neither contained in the Investment Ordinance nor in Circular 4/2011 issued by the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht - BaFin*) which interprets the Investment Ordinance.

Investment Regulatory Framework

Pursuant to § 112 of the German Investment Law (*Investmentgesetz – InvG*), the constitutive key features of a single hedge fund are (1) a wide spectrum of eligible assets (as opposed to UCITS III funds a German hedge fund may also invest in precious metals and interests in enterprises if the market value of such interests can be determined), and (2) the use of short sales and/or leverage by way of principally unrestricted borrowing or the use of derivatives.

UCITS III funds employing hedge fund strategies, do not meet these key features as they may neither employ short selling nor unrestricted leverage.

Consequently, from an investment regulatory perspective, such alternative UCITS funds are not to be considered as hedge funds.

Insurance Regulatory Consequence

This circumstance also directly has effects from an insurance regulatory perspective as the hedge funds quota tracks the investment regulatory qualification. Although there is a certain opening clause by including “funds with a corresponding investment policy”, in our view a UCITS III-vehicle that does not meet any of the constitutive key features of a German single hedge fund may not be deemed to have such “corresponding investment policy”.

UCITS III funds that employ hedge fund-strategies therefore do not count against the hedge funds quota.

Classification Depending on Underlying

Hence it has to be examined against which other quota such vehicles are to be counted against.

In the absence of any specific regulations, the general provisions concerning shares of domestic and foreign funds apply.

Pursuant to BaFin’s Circular 4/2011, depending on the underlying of a domestic or foreign fund unit within the meaning of § 2 (1) no. 15 to no. 17 AnlV, an attribution on a look-through basis to, among others, the so-called “risk capital-quota” (§ 3 (3) sentences 1 and 3 AnlV) is required if such funds invest in the relevant underlyings and a calculation on a look-through basis is possible.

Such calculation on a look-through basis is not compulsory though. In its discretion, an insurance undertaking may alternatively attribute the total value of the respective fund units to the relevant quota regardless of such fund’s composition. BaFin clarifies however that due to the requirement of a qualitative capital management (cf. § 1 (2) and (3) AnlV), insurance undertakings should not abstain from a possible calculation on a look-through basis.

Pursuant to BaFin’s Circular 4/2011 the extent to which direct or indirect investments in shares and other risk capital are acceptable within the relevant quota in a given case, crucially depends on the risk bearing ability of the relevant insurance undertaking. In particular it is determined by the amount of the debit balance and the nature and amount of valuation reserves of the restricted assets. Furthermore, it is to be taken into account if loss risks may be hedged. Consequently, risk capital investments may only be effected on a larger scale if value fluctuations can be compensated.

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Pursuant to § 3 (6) AnlV, BaFin is authorized to minimize the share of risk capital investments to ten per cent of the guarantee assets and the other restricted assets on a case-by-case basis if this is necessary to preserve insurance holders' interests.

Future Prospects

The fact that UCITS III funds that employ hedge fund strategies do not count against the hedge funds quota strengthens the flexibility of insurance undertakings' capital management. However, against the background of an increasing market share of such vehicles and structures that become more and more complex, we expect that German legislation and BaFin will attentively monitor the further development of this segment and—in case of any “undesirable developments” bypassing provisions that apply to hedge fund-investments by way of structuring UCITS III-compliant vehicles—face such developments with more restrictive regulations.

¹ Ordinance on the Investment of Restricted Assets of Insurance Undertakings (*Anlageverordnung – AnlV*) dated December 20, 2011 (BGBl I 2001, 3913), last amended by the fourth ordinance on the modification of the Investment Ordinance dated February 11, 2011 (BGBl I p. 250).