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SPECIAL REPORT

# HOW TO START A HEDGE FUND IN THE EU 2012

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# GERMANY: TRANSPARENT INVESTMENTS

ACHIM PÜTZ OF DECHERT GIVES AN OVERVIEW OF THE BENEFITS OF A MANAGED ACCOUNT PLATFORM FROM THE PERSPECTIVE OF A GERMAN INSTITUTIONAL INVESTOR



## Achim Pütz

is a partner in Dechert's financial services group and has extensive experience in advising both German and international clients on traditional and alternative fund structuring, structured debt products and all aspects of investment strategy regarding complex alternative structures.

**D**uring the financial crisis of 2008, many hedge fund managers exercised their right to restrict fund liquidity, using their frequently underestimated legal powers to put in place gates, suspend redemptions and even segregate illiquid fund assets for years in closed-end vehicles (so-called 'side pockets'). Among other factors, this resulted in a substantial deterioration of liquidity for investors.

Single security deposit accounts held in trust – which are known as segregated managed accounts – emerged from the crisis as a favoured structural solution, as they not only offer investors full transparency, but also an effective protection against the above-mentioned liquidity constraints. In a segregated managed account, the portfolio's liquidity derives from the liquidity set by the underlying financial instruments, rather than by conflicting activities of other investors who may force the hedge fund manager to liquidate securities positions and thus take measures to restrict liquidity.

## STRUCTURAL SOLUTIONS

The experiences gained from the financial crisis caused Bayerische Versorgungskammer (BVK), the largest German public pension scheme – with €50bn AUM – to carry out an internal analysis of their existing hedge fund investments. This analysis indicated that it is reasonable for a large investor such as BVK to invest in single hedge fund strategies via managed accounts (MACs).

Therefore, BVK decided to structure and launch its own BVK-controlled managed account platform (MAP).

## LEGAL STRUCTURAL OBJECTIVES

With regard to the legal set-up of the MAP, the following objectives in particular had to be taken into account:

- BVK, as the managing and representative body of twelve professional and local pension schemes (BVK Pension Funds) wanted to ensure that the BVK Pension Funds are the sole eligible investors for the MAP and the portfolios of different investment managers (portfolio managers) to be integrated. The assets managed by the portfolio managers should be held directly by the respective sub-fund and controlled by the MAP and its service providers.
- Any dependence on the MAP operator and other service providers to the MAP should be avoided. In the interest of the BVK Pension Funds, it should be

possible to replace these service providers as easily as possible.

- It was necessary to safeguard the eligibility of the indirect investments of the BVK Pension Funds under the provisions of German investment law and insurance supervision law.

## STRUCTURING OF BVK MANAGED ACCOUNT PLATFORM

On the basis of the above structural objectives, it was determined that the following legal structure – as a platform vehicle – would be used: a Luxembourg Specialised Investment Fund (SIF) pursuant to the Law on Special Investment Funds dated 13 February 2007 (SIF Act), in the form of a stock corporation (Société Anonyme – S.A.) with variable capital (Société d'Investissement à Capital variable – SICAV) (SIF SICAV S.A.).

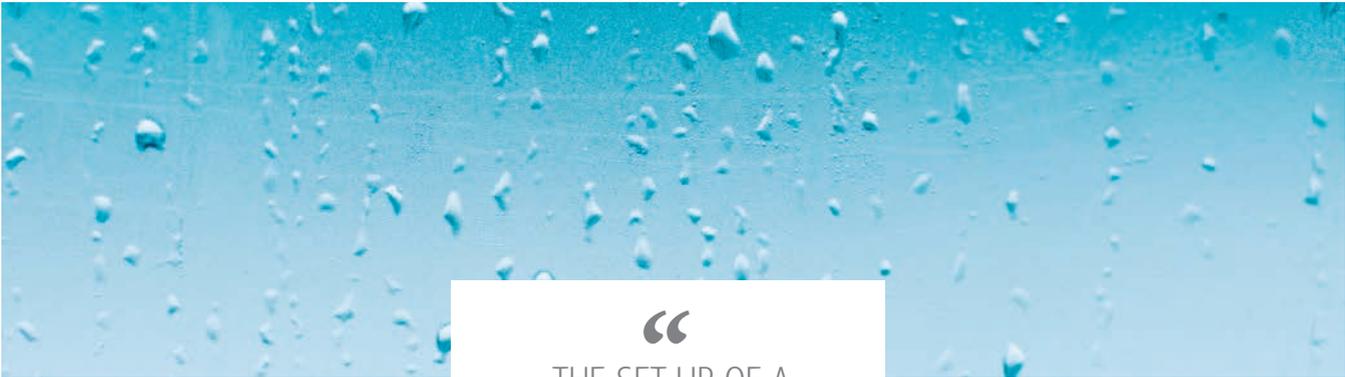
The reasons for choosing a Luxembourg SIF include its flexibility regarding investment policy, the lean regulatory regime accommodated to such vehicles (supervised by the Commission de Surveillance du Secteur Financier – CSSF), as well as its possible classification as a foreign collective investment scheme, from a German regulatory perspective. The legal form of a Luxembourg stock corporation was selected in order to set up an independent corporate fund (rather than a contractually structured special fund dependent on a management company), which grants voting rights to its investors and is independent of the integrated service providers.

Moreover, for efficiency reasons, the SIF SICAV S.A. was structured as an umbrella fund with several sub-funds.

The SIF SICAV S.A. has a central administrator and a central custodian bank.

The MAP's ongoing activities are co-ordinated and supervised by a specialised service provider, the MAP operator, which has been integrated into the MAP by way of a tailored service agreement. The MAP operator is responsible, among other things, for the following:

- Legal and operational launch of the MAP and new MACs on the MAP (as well as their liquidation);
- Legal and operational integration of fund infrastructure into the MAP and the negotiation of service contracts;
- Initial and continuous operational due diligence of the hedge fund managers and the fund administrator, the custodian bank and the prime brokers, if applicable;
- Recommendation of investment guidelines for hedge fund managers and negotiation of investment management agreements;



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”

- Operative launch of commercial relationships and negotiation of broker agreements with prime brokers;
- Risk management, controlling and monitoring of compliance with investment guidelines, as well as examination of counterparty risks; and
- Provision of online reporting, allowing BVK to review any and all positions of the MACs at any time.

BVK thus outsourced all middle office and back office operations to specialised service providers, without giving up the unrestricted control of the MAP as shareholder, or the ability to replace the service providers at any time, pursuant to the relevant agreements.

#### LEGAL QUESTIONS

Within the structuring process, a number of specific legal questions arose, the key issues of which are discussed as follows:

#### PERMISSIBILITY OF AN INVESTMENT IN MAP UNDER INSURANCE SUPERVISION LAW

The BVK Pension Funds are subject to state regulation, which is largely in parallel to the regulatory framework governing the investments of German insurance companies. Therefore, it was necessary to structure the SIF SICAV S.A. and each individual MAC in a way to meet these regulatory requirements.

#### UMBRELLA VERSUS STAND-ALONE

An initial question regarding structure involved whether the launch of one or several umbrella SICAV or the use of a stand-alone SICAV would be advantageous for each managed account with regard to the legal and practical consequences. It was determined to select an umbrella SICAV, primarily for reasons of practicability and possible cost savings. Since an umbrella SICAV is a single legal entity (despite a basically unlimited number of possible sub-funds), it can be managed under corporate law in a more efficient way than a number of individual SICAVs, each with an executive board, general shareholders' meetings, disclosure requirements, and so forth. In the case of an umbrella SICAV, efforts to amend organisational documents would not need to be undertaken for individual investment vehicles. The legal relationships with central

service providers can also be implemented and later amended in a more efficient way and with less documentation requirements.

This increased efficiency should result in considerable cost savings with increasing volume. Furthermore, the launch of new sub-funds is easier than the launch of a new SIF SICAV S.A. investment vehicle for each individual managed account.

A potential disadvantage to using an umbrella SICAV might be increased liability risks due to the umbrella structure. Any residual risks existing in this regard were analysed for the United States and the UK, which are eligible as potential (prime) broker locations. Such risks were assessed as negligible, provided that appropriate contractual ring fencing protections are included in the relevant agreements.

#### INTEGRATION OF A CENTRAL INVESTMENT MANAGER

Another important issue to be resolved was the question of whether the respective portfolio managers should be directly instructed by the MAP as to the management of the relevant sub-fund, or whether it would be beneficial to interpose the MAP operator and/or a group company as a central investment manager to authorise the portfolio manager within the framework of a sub-delegation.

During the discussions with the various platform operators it appeared, for a number of reasons, that the additional assignment of the function of an investment manager to a platform operator might not be practicable.

Furthermore, a benefit of not having a central investment manager is that there is no risk that all sub-funds of the MAP would be affected if a central investment manager fails.

Accordingly, the MAP was structured without interposing a central investment manager – since this was determined to be more beneficial in principle – provided that adequate security mechanisms are implemented in the contractual provisions with the MAP operator and the portfolio managers.

The set-up of a proprietary MAP for investments in hedge funds (and other asset classes) may considerably increase the transparency and security of such assets without causing higher costs for investors in the medium term. These investment solutions will likely continue to make their way into the market for the benefit of insurance holders, pension fund contributors and/or other end-investors. ■

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