

The placement of foreign hedge funds in Germany

by Uwe Bärenz and Sebastian Käpplinger, P+P Pöllath + Partners, Berlin

THE GERMAN INVESTMENT ACT (*INVESTMENTGESETZ*; INVESTMENT ACT) GOVERNS DOMESTIC INVESTMENT FUNDS AND THE PLACEMENT OF FOREIGN INVESTMENT FUND UNITS. HEDGE FUNDS HAVE BEEN OFFICIALLY RECOGNISED BY THE INVESTMENT ACT SINCE ITS MODERNISATION IN 2003. HOWEVER, THE INVESTMENT ACT APPLIES ONLY TO CERTAIN TYPES OF HEDGE FUNDS. WHETHER THE INVESTMENT ACT IS APPLICABLE TO A FOREIGN HEDGE FUND HAS SIGNIFICANT CONSEQUENCES WITH REGARD TO PLACEMENT RESTRICTIONS, TAXATION AND OVERALL INVESTOR APPEAL.

Hedge funds subject to the Investment Act

Foreign investment fund units as a threshold

Key for the applicability of the Investment Act to a foreign hedge fund is whether the fund's units qualify as foreign investment fund units (*ausländische Investmentanteile*).

Until the amendment of the Investment Act by the Investment Amendment Act at the end of 2007, foreign investment fund units were defined as units in foreign investment funds issued by a company with its principal office abroad. Foreign investment funds (*ausländische Investmentvermögen*) are investment funds subject to a foreign jurisdiction. Investment funds (*Investmentvermögen*) are defined as pooled funds being invested in eligible assets pursuant to the principal of risk diversification. This definition requires a case-by-case review of the fund's investment guidelines; a task which can be rather cumbersome.

The Investment Amendment Act, therefore, sought to simplify the qualification of foreign hedge funds, and other funds in general, by adding two formal criteria to

the previous definition of the Investment Act. Foreign investment fund units are still units in foreign investment funds issued by a company with its principal office abroad, but one of the following requirements must also be met:



Uwe Bärenz, Partner
P+P Pöllath + Partners
tel: +49 (30) 253 53 122
e-mail: uwe.baerenz@pplaw.com
web: www.pplaw.com

- existence of an investor's right to redeem the fund units; or
- supervision for collective investment schemes over the fund's investment company in the jurisdiction of the company's principal office.

Investment fund

Regardless of the more formal approach under the amended Investment Act, foreign investment fund units must still be units in an investment fund. As mentioned above, investment funds are pooled funds which are invested in eligible assets pursuant to the principle of risk diversification.

- **Risk diversification.** A fund is invested pursuant to the principle of risk diversification if it has more than three assets carrying different risks. However, mere risk diversification of the fund's assets is not enough to trigger the qualification of an investment fund under the Investment Act. Almost every business enterprise has assets with variable risks on its balance sheet. To further limit the Investment Act's scope, the activities of the vehicle must be targeted at investing pursuant to the principle of risk diversification. The reasoning behind this distinction is investor protection. Funds classified as investment funds shall only carry investment risks, but not any additional operational risks. Therefore, a group holding company would generally not fall within the scope of the Investment Act. The group holding company's assets would have been the result of business decisions for structuring the business group, but not the result of investment decisions. A similar analysis applies to private equity funds. Private equity funds typically seek to maximise the value of their portfolio companies by exercising control. Their activities and the success thereof depend on how successfully they are able to add value to their portfolio companies. Private equity funds, therefore, carry risks beyond mere investment activities.
- **Eligible assets.** In addition to investing pursuant to the principle of risk diversification, an investment

fund must be invested in eligible assets. According to a draft letter ruling issued by the German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*; BaFin) at least 90% of the fund's assets must consist of eligible assets. Otherwise, a fund is not considered an investment fund under the Investment Act.

Generally, eligible assets are securities, money market instruments, derivatives, bank accounts, real property and real estate-related assets, certain real estate companies, as well as units in domestic and comparable foreign investment funds. Domestic hedge funds which are subject to the Investment Act and comparable foreign hedge funds are also allowed further asset classes (e.g., equity interests in companies) but restricted on other asset classes (e.g., real estate).

Redemption right/supervision

As mentioned above, to qualify as foreign investment funds units, the investor must have a right to redeem the units or the investment company must be subject to supervision for collective investment schemes in the jurisdiction of its principal office.

BaFin recently sought to specify those two requirements in a draft letter ruling. The redemption requirement shall be met as long as redemption is possible at least once within two years.

As for the requirement of supervision for collective investment schemes, BaFin maintains that supervision for collective investment schemes is government supervision aimed at investor protection. Consequently, mere government supervision of the integrity and efficiency of the markets or tax supervision does not suffice, nor does a mere registration of the closed-end fund at its principal office.

The placement regime for foreign hedge funds under the Investment Act

If the foreign hedge fund's units have passed the threshold of foreign investment fund units, the Investment Act is applicable to the placement of these units in Germany.

In addition, the door has been opened to the applicability of the German Investment Tax Act (*Investmentsteuergesetz*; Investment Tax Act).

Single hedge funds

The placement of investment hedge fund units under the Investment Act depends on whether the fund is classified as comparable to a fund with additional risks (*Sondervermögen mit zusätzlichen Risiken*) or whether it compares to other categories of regulated investment funds.

A fund with additional risks is defined as a fund which fulfills the following requirements:

- the fund must be an investment fund and, as such, adhere to the principle of risk diversification;
- the fund shall be allowed to invest in the following eligible assets without any restrictions: securities, money market instruments, derivatives, bank accounts, units of certain investment funds, silent participations, precious metals and equity interests in companies. A fund investing in assets other than the aforementioned (e.g., in real estate) cannot qualify as a fund with additional risks, i.e., a hedge fund;
- the investment guidelines of the fund must allow for investment strategies involving additional risks. Recognised investment strategies are only the increase of the investment exposure by using unlimited borrowing or derivatives (leverage) or the sale of assets on account of the investors even though at the time of

P+P Pöllath + Partners Attorneys · Tax Advisors

P+P

31

P+P's 25 partners and a total of over 90 attorneys and tax advisors focus solely on legal and tax advice on acquisitions (M&A), private equity/venture capital, real estate, family offices and asset management.

P+P advisors have consistently been ranked at the top of professional listings in national and international surveys. In 2007 and 2008, many P+P partners have been ranked as *leading* or *highly recommended* in private equity, M&A and tax. In these specialized areas, P+P offers state-of-the-art expertise, judgment and independence, as well as full service:

Transactions

corporate acquisitions and structuring, private equity/venture capital/alternative assets fund structuring and screening, listing and delisting, succession and tax structuring, and real estate

Asset Management

strategy, succession (including family offices, entrepreneurs, investment banks, funds), financial products, trusts, foundations, tax rulings and audits, and real estate

P+P is fully independent and works with leading professionals from other firms, nationally and internationally, as well as with other advisors, banks, etc. The majority of our clients and mandates are based abroad. For more information, including pro bono work and various P+P foundations:

www.pplaw.com

P+P Berlin
Potsdamer Platz 5
10785 Berlin
Tel: +49 30 25353-0
Fax: +49 30 25353-999
ber@pplaw.com

P+P Frankfurt
Zeil 127
60313 Frankfurt/Main
Tel: +49 69 247047-0
Fax: +49 69 247047-30
fra@pplaw.com

P+P Munich
Kardinal-Faulhaber-Strasse 10
80333 Munich
Tel: +49 89 24240-0
Fax: +49 89 24240-999
muc@pplaw.com

sale these assets are not owned by the fund (short sales); and

- finally, the investment guidelines must limit the fund's investment in unlisted equity interests in companies (private equity) to 30% of the fund's assets.

If a foreign hedge fund is classified as comparable to an investment fund with additional risks, its units must not be distributed by public placement. The Investment Act defines public placement as any distribution by way of public offering, public marketing or similar means. Often, the exact borderline between a private placement and a public placement is difficult to determine. However, the Investment Amendment Act implemented some safe harbour provisions into the Investment Act. For instance, a placement of fund units is deemed a private placement if the units are exclusively distributed to certain institutional investors, such as credit and financial services companies.

If the hedge fund does not qualify as comparable to an investment fund with additional risks, its placement is largely similar to the placement of fund of fund hedge funds described below.

Fund of fund hedge funds

In contrast to single hedge funds, the public placement of foreign fund of funds, which are invested in investment funds with additional risks, is possible. Precondition for a public placement is that the fund of fund meets the placement requirements for foreign investment funds under the Investment Act. These placement requirements focus mainly on investor protection. Accordingly, there must be a comprehensive sales prospectus providing all information relevant for an investment decision, including, for example, the latest annual or semi-annual financial report. Among others, a further placement requirement is, for instance, that the fund's assets be kept in custody of, or at least be supervised by, a custody bank.

The fund of fund must notify BaFin of its intention to distribute the fund units within Germany. If BaFin does not object within three months, the units can be publicly distributed in Germany. The ongoing placement of the fund units is subject to BaFin supervision.

Taxation

The German Investment Tax Act (*Investmentsteuergesetz*) applies to the taxation of income arising out of such hedge funds which are investment funds under the Investment Act. In principle, the Investment Tax Act aims for transparent taxation of foreign investment funds. This is true, however, only as long as the investment fund complies with extensive disclosure requirements set out in the Investment Tax Act. Naturally, this is a difficult option for foreign hedge funds. In case of non-disclosure, a prohibitive flat tax is levied upon fund investors. Foreign hedge funds, however, can avoid this flat tax if they do not qualify as investment funds under the Investment Act.

Hedge funds subject to general law

As indicated above, a different regulatory and tax regime applies to hedge funds which are not subject to the Investment Act.

Regulatory regime

From a regulatory perspective, the placement of hedge funds which are not subject to the Investment Act must comply with the prospectus requirements of either the German Sales Prospectus Act (*Verkaufsprospektgesetz*; Sales Prospectus Act) or the German Securities Prospectus Act (*Wertpapierprospektgesetz*; Securities Prospectus Act). Whereas the Securities Prospectus Act is closely tied to the EC Prospectus Directive and the EC Prospectus Ordinance, the Sales Prospectus Act is a peculiarity of German law.

The Sales Prospectus Act mainly applies to the placement of non-negotiable instruments such as limited partnership interests. In contrast, the scope of the Securities Prospectus Act is defined by negotiable securities. Both Acts require that a prospectus be filed with BaFin prior to a public placement of units in Germany. However, both Acts differ in their substantive regulation. For instance, under the Securities Prospectus Act, a prospectus need not be filed if the minimum subscription amount or minimum denomination is €50,000. In contrast, a minimum denomination of €200,000 is necessary in order to opt out of the Sales Prospectus Act.

Another issue from a regulatory perspective is whether these hedge funds are required to comply with the license requirements of the German Banking Act (*Kreditwesengesetz*; Banking Act). BaFin also applies the Banking Act to foreign-based banking and financial service providers without any branches or representative offices in Germany if investors are specifically targeted within Germany. Even though this view has been contested in the courts, it is still standard BaFin practice. As a result, such foreign hedge funds might come within the realm of the license requirements under the Banking Act provided, of course, that they fall within its license requirements. For the time being, with some certainty, foreign hedge funds are not subject to the banking and financial services license requirements of the Banking Act. However, this might change under a proposed amendment of the Banking Act. According to the proposed bill, the purchase and sale of financial instruments on account of investors shall be regulated if the economic results of the transaction can be attributed to the investors of the vehicle.

Tax regime

The taxation of investors in foreign hedge funds which are not subject to the Investment Act also differs from the taxation of investors in such hedge funds which are subject to the Investment Act. Income derived from hedge funds which are not subject to the Investment Act is taxed on the basis of general income taxation provisions. Accordingly, a hedge fund might be transparent for tax purposes if established as a foreign partnership or opaque if established as a foreign entity. In addition, the anti-offshore provisions of Germany's Foreign Transaction Tax Act (*Außensteuergesetz*) might apply.

Contact us:

P+P Pöllath + Partners

Potsdamer Platz 5, 10785 Berlin, Germany

tel: +49 (30) 253 53 0

e-mail: ber@pplaw.com

web: www.pplaw.com

hedge.funds WORLD

Zürich 2008

1 - 4 December 2008, The Dolder Grand, Zürich, Switzerland



Europe's Most Senior Gathering Of Hedge Funds & Their Investors

34 End Investors Already Confirmed

- **11th successive year:** an unparalleled track record you can rely on
- **Always over 250 senior level attendees:** the people you want to meet
- **Over 40% ratio of end-investors:** the place to meet peers and do business

Gold sponsor



Bronze sponsor



Event partner



Exhibitors



Organised by



Register before
19th September 2008
and SAVE up to £319!

“ We need more forums
like this great event ”
Mario Guardia,
Managing Director,
Caja de Ingenieros
Gestion

4 days, 70+ speakers!

OUTLOOK FOR 2009



Peter Clarke
Chief Executive Officer
Man Group plc

Hear first-hand how a seasoned pro has read the recent market conditions and the predictions he's making for 2009.

ROLE OF CENTRAL BANKS



Philipp Hildebrand
Vice-Chairman
Swiss National Bank

Hear one of Europe's most respected central bankers comment on the challenges facing the global banking system and the role of central banks in the current environment.

HEDGE FUNDS & PRIVATE EQUITY



John Studzinski
Member of the Executive Committee
Blackstone Group

Hear why the marriage between private equity and hedge funds could be such a big deal for end-investors!

ALPHA GENERATION IN PRACTICE



Gerlof de Vrij
Head of Global Tactical
Asset Allocation
APG Investments

Learn how Europe's largest pension fund is generating pure alpha through dynamic and diversified top-down investment strategies across all assets and risk factors.

ALPHA-BETA SEPARATION



Jaap van Dam
Chief Strategist
PGGM Investments

Understand the investment and fund selection thinking behind PGGM's construction of an alpha-beta separation strategy.

Response form

Fax Back to +44 (0)20 7242 1508

- Yes! Please register me for the conference Yes! Please send me the conference brochure
- Yes! I am interested in sponsorship opportunities

Name:

Job title:

Company:

Address:

Tel: Fax:

Email:

Contact: Julia Wallace Tel: +44 (0) 20 7092 1276 or email: julia.wallace@terrapiinn.com

Event code: EM

Book now, call +44 (0)20 7242 2324 or online at www.terrapiinn.com/2008/zurich/