Plenary 4

The Rapidly Evolving Activities of Hedge Funds

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Regulation of Hedge funds in Germany

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Structure of the Presentation

• An Overview on the New Legal Framework
• Setting up and regulation of Hedge Funds
• Current Product Registration
An Overview on the New Legal Framework
Investment Modernisation Act

Until January 1, 2004

- **Investment Companies Act (KAGG)**
  Regulatory and Tax Framework for German Funds

- **Foreign Investment Act (AuslInvG)**
  Regulatory and Tax Framework for Foreign Funds
## Investment Modernisation Act

### Objectives

- Transformation of the Undertakings for Collective Investment in Transferable Securities-Directive (UCITS-Directive) in German Law
- Change of taxation for Foreign Funds
- Strengthening of the German Fund Market
- Regulation of Hedge Funds to strengthen the German Market and to protect the investor
Investment Modernisation Act

Since January 1, 2004

- **Investment Act (InvG)**
  Regulatory Framework for German and Foreign Funds

- **Investment Tax Act (InvStG)**
  Tax Framework for German and Foreign Funds
Investment Act

Investment Act (in force since January 1, 2004)

• Provides for the first time a legal framework for the establishment of domestic single hedge funds and funds of hedge funds

• Allows the public distribution of foreign funds of hedge funds

• Allows the private placement of foreign single hedge funds
Setting up and regulation of Hedge Funds
# Registration

## Registration with the BaFin

- German Single-Hedge Funds (§ 112 InvG – Funds with additional Risks)
- German Funds of Hedge Funds (§ 113 InvG – Funds-of-Funds with additional Risks)
- Foreign Funds of Hedge Funds (§ 139 InvG – Obligation to Notify)

## Registration with the BaFin not required and not possible

- Foreign Single-Hedge Funds and Funds of Hedge Funds
- But public distribution is prohibited = Only private placement
## Provisions for German Single Hedge Funds

- No investment restrictions apart from the following:
  - They have to comply with the principle of risk diversification.
  - They have to provide for both or either of:
    - The use of short sales.
    - The use of leverage (Both or either by derivatives or loans).
  - They have to restrict themselves to a broad catalogue of admissible assets.
  - They may not invest more than 30% of their NAV into unlisted securities.
Investment Restrictions for German Funds of Hedge Funds (1)

- Funds of Hedge Funds may only invest in:
  - Target Funds
    - Minimum: 51% of NAV in Funds
  - Liquid assets (bank deposits, money market instruments)
    - Maximum: 49% of NAV
  - Besides, transactions to hedge currency risk are admissible
Investment Restrictions for German Funds of Hedge Funds (2)

Requirements for target funds of funds of hedge funds:

- Only German single hedge funds (§ 112 InvG - Sondervermögen mit zusätzlichen Risiken) as well as investment stock corporations and foreign single hedge funds with comparable investment policies.

- Target funds must be domiciled in states actively prohibiting money laundering and must not invest in other target funds.

- Target funds may not themselves invest in other target funds (but investments in other investment funds are possible).
Management Vehicles

- **Establishment of an Investment Management Company**
  (§ 6 InvG - Kapitalanlagegesellschaft)
  Minimum share capital: 730,000 Euro

- **Establishment of an Investment Stock Corporation**
  (§ 96 InvG - Investmentaktiengesellschaft)
  - New legal form of an investment company with variable capital (comparable to a Luxembourg SICAV)
  - Minimum share capital: 300,000 Euro
Management Vehicles

- Permission by the BaFin to an existing Investment Management Company to make amendments to its articles of association

- Outsourcing
  - Portfolio Management as own business activity
  - Outsourcing of the Portfolio Management
    - Company with licence for the purpose of asset management
    - Subject to effective public supervision
Business Licence (1)

- Articles of Association
- Business plan
- Description of the competences of the management
- Description of the organisation and the rules of conduct
- CV`s and any other information about the persons responsible for the management of Single and Fund of Hedge Funds
- § 120 InvG – Requirements with Respect to the Persons responsible for Investment Decisions of Fund of Hedge Funds
  - General professional competence
  - Sufficient practical experience
  - Knowledge concerning the investment in funds with additional risks and comparable foreign investment funds
Business Licence (2)

- Description of the Riskmanagement and Riskcontrolling
  - Single Hedge Funds
    - § 119 InvG Risk Measurement Systems
    - Derivative Ordinance (Qualified/Simplified Method)
    - § 25 a (1) No. 1 Banking Act
  - Fund of Hedge Funds
    - § 113 (5) sentence 4 InvG
    - Continuous monitoring of the target funds with respect to the compliance with the investment strategies and risks
    - Regularly provided by the target funds with generally recognized risk indicators
Business Licence (3)

- Meeting with Section „Supervision of Hedge Funds“ and Risk Modelling Group
- Inspection of Riskmanagement and Riskcontrolling
- Talks with the Hedge Fund Management
Business Licence (4)

Hedge Fund regulation as a continuous process

- Onside Inspections by Auditors
  - Annual Report/Semi-Annual Report for each Fund
  - Annual Financial Statement by the firm

- Onside Inspections by the BaFin
  - § 44 (1) sentence 2 Banking Act
  - Audits by the BaFin, even without a special cause

- Regular Visits by the BaFin
Current Product Registration

- Applications of German Single Hedge Funds 9
  (Number includes applications of two „Investmentaktiengesellschaft“)

- Applications of German Fund of Hedge Funds 7

- Commencement of public distribution of Foreign Fund of Hedge Funds 8