



Plenary 4

The Rapidly Evolving Activities of Hedge Funds

Mr. Horst Nottmeier

Director of the Hedge Funds Division
Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin),
Germany

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Regulation of Hedge funds in Germany

Panelist: Dr. Horst Nottmeier,

Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)

German Federal Financial Supervisory Authority

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 (AusInvG)**

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 diversifikation
 - 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