German hedge fund legislation: modernised but still old-fashioned

By Norbert Lang[*]

I. Introduction

On January, 1st 2004 the new German Investment Act (Investmentgesetz - "InvestG") has entered into force and has established a new legal frame for funds.[1] Especially hedge funds are regulated by German law for the first time.[2] Nevertheless the solutions, used to establish hedge fund investments in Germany in the past, remain legal and it is argued that they will continue to play a practical role.[3] The new InvestG on the one hand modernises German law, but on the other hand still clings to a somewhat old-fashioned regulatory approach. At the same time there are efforts at the European level to harmonise European hedge fund legislation. As a result an analysis of the German hedge fund regulation has to deal with three different, partly overlapping regimes: A past, that is still not bygone (II.), a present which is still not modern at all (III.), and a near future that will bring more changes and probably lead to an up-to-date regulation (IV.). After an introduction to these three regimes, I shall conclude with a short summary pointing out the main deficits of the new German legislation (V).

II. A past not yet bygone

Until the beginning of this year the legal basis for hedge funds in Germany was the Investment Companies Act (Kapitalanlagegesellschaftsgesetz - "KAGG"). That law followed a kind of opt-in model for hedge funds.[4] It was only applicable to invest-

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[1] Investmentmodernisierungsgesetz (Investmentmodernisation Act) of 15 December 2003, Bundesgesetzblatt No. 62, 19.12.2003 http://217.160.60.235/BGBL/bgbl1f/bgbl103s2676.pdf.

[2] *Von Livonius*, WM 2004, 60, 62 ff.; *Lang*, WM 2004, 53, 58 et sq.

[3] Börsen-Zeitung, 23.10.03 "Hedge Funds made in Germany"; Steck, Legal Aspects of German Hedge Fund Structures, Working Paper No. 12 of the institute for law and finance, http://www.ilf-frankfurt.de/publication_file.php4?file_id=9, p. 25.

[4] *Steck* (supra, note 3) p.7 speaks of "optional regulatory law".

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ment banks which were in full compliance with the definitions of the KAGG.[5] Although other investment companies were not prohibited to offer investments in hedge funds they could not benefit from the respective provisions, i.e, they were not allowed to use the terms "Kapitalanlagegesellschaft", "Investmentgesellschaft" or "Investmentfonds" because these terms were reserved for investment companies who performed business in accordance with the KAGG pursuant sec. 7 para. 1 KAGG.

For hedge funds or funds of hedge funds it was practically impossible to fulfil the provisions of the KAGG for different reasons. In sec. 9 para. 5 of the KAGG the use of leverage strategies which are typical for hedge funds[6] was prohibited for German investment companies. In sec. 9 para. 4 KAGG the taking of credits for a Sondervermögen (collective investment scheme) was restricted to 10 per cent of the value of the Sondervermögen. This limited short sale strategies which are also typical for hedge funds.[7] Other relevant restrictions could be found in sec. 8 to 8k KAGG. For this reason under the provisions of the KAGG, the promotion of hedge funds in Germany was not possible. But since the KAGG offered an opt-in model and, moreover, it was not forbidden to establish investment vehicles that were not in accordance with the KAGG, investment companies established alternative ways of promoting hedge funds in Germany.

Many hedge funds are incorporated in so called offshore jurisdictions. Therefore, besides the KAGG, the Foreign Investment Act (Auslandinvestmentgesetz - "AuslInvestG") had to be taken into account. This act applies to funds governed by foreign law, which consisted of securities, certified receivables from money loans, cash deposits and real estate which additionally had to be invested according to the principle of risk diversification. These are so-called foreign investment units. These foreign investment units did fall under the AuslInvestG and therefore the provisions set forth in the first chapter of the AuslInvestG were applicable if these units were distributed by public offering or in a similar way. The provisions were not applicable if the unit was only distributed by private placement. However the tax regime that was imposed by the third section of the AuslInvestG was applicable in public sales and private placements. This has important effects on so-called black-funds. If a fund was neither admitted to public sale nor listed on a stock exchange, there was punitive taxation according to sec. 18 para 3 AuslInvestG. According to sec. 7 para. 1 AuslInvestG, a foreign investment company was obligated to inform

[5] Bankrechtshandbuch - *Köndgen* 2nd edition, 2001, Volume III, Sec. 113 margin-no. 34.

[6] *Steck*, (supra, note 3) p. 6.

[7] *Steck*, (supra, note 3), p. 7.

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the BaFin of the intention to sell funds. If this intention did not comply with the legal requirements, the German Federal Authority for Financial Services (Bundesanstalt für Finanzdienstleistungen - "BaFin") could prohibit the public distribution of the fund. These restrictions were basically the same as in the KAGG and so selling hedge funds in Germany was practically impossible for foreign investment companies, even if it was possible to create a GmbH which uses typical hedge fund strategies and lets investors participate via equities.[8]

So until now, alternative structures were developed, especially so-called index certificates and performance linked notes.[9]

Index certificates are securities with or without maturity, the value of which is guided by a somehow artificially composed reference asset. In practice the issuer which is usually a German bank pays the amount stated in the respective reference asset to the investor at a defined time. The foreign investor works as a fund sponsor and invests the amount into different hedge funds. The return is paid back to the German bank. The German bank divides the whole investment into certificates, which are distributed to individual investors. In case of maturity or cashing the amount corresponding the actual value of the index is paid back.[10]

The second construction in order to avoid the application of KAGG and AuslInvestG are the so-called performance linked notes. As above, a German bank divides an investment into certificates which is distributed to investors, but this time the certificate is not linked to a defined index but directly to a hedge fund or a fund of hedge funds.[11]

In both cases the AuslInvestG was not applicable, and so via index certificates and performance linked notes, German individual investors were able to invest in hedge funds or funds of hedge funds without being subject to any legal restrictions and without being subject to any punitive taxation.

III. A present - still sort of old-fashioned

With the new InvestG, which replaced both the old KAGG and the AuslInvestG, the legal frame changed. Now in sec. 112 InvestG, hedge funds are the subject of a

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[8] *Steck*, (supra, note 3), p. 8.

[9] *Kayser/Steinmüller*, FR 2002, 1270, 1276 et sqq.

[10] *Luttermann/Backmann*, ZIP 2002, 1017, 1019 f.; Kayser/Steinmüller, (supra, note 9) at 1277 et sq.

[11] *Kayser/Steinmüller* (fn 9), at 1276 et sq.

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new legal regime. There is a legal definition of what is considered as a hedge fund in German law in sec. 112 InvestG - even if the InvestG does not use the term hedge fund because of the difficulties of defining what a hedge fund is, but uses instead the expression "Sondervermögen mit zusätzlichen Risiken" (investment scheme with additional risks). According to that definition, a fund is considered a hedge fund, if it uses either leverage or short-strategies or both and is not restricted in the choice of its assets. Hedge Funds are recognised by German law if they adhere to a certain legal standard. The most important restriction now is that hedge funds can be distributed only by private placement and not by public placement. At the beginning of the law-making process, the legislator wanted to allow hedge funds only the distribution via so called special funds (Spezialfonds) in which only institutional investors are allowed to invest.[12] Against this originally intended restriction it was claimed that special funds are a German legal speciality only and unknown in other countries and so foreign investors - institutional and private ones - would be excluded from investing in German hedge funds.[13] The building up of a German hedge fund industry was one of the legal aims of the new InvestG,[14] therefore it would have been very counterproductive to exclude foreign investors from investing in German hedge funds. Accordingly the draft was changed. Distributing hedge funds is now allowed to all kinds of investors via private placement. Even if private placements are not new within the law of German Capital markets, the legal framework for placements to be considered as non-public or private is still uncertain. According to the Selling prospectus Act (Verkaufsprospektegesetz - "VerkProspG") a prospectus is necessary for public placements only. Therefore for private placements a prospectus is not needed. However, since public placement is not legally definied, there are still discussions about when a placement has to be considered as being public.[15] The difficulty is even greater when trying to define the term private placement under the new InvestG. Whereas under the VerkProspG the need of a prospectus is necessary for providing adequate information about the placement to the investor,[16] this argument is not possible for the hedge fund regime

[12] Sec 112 para. 2 of the draft bill, http://www.bvi.de/downloads/invmodG_gesetzentw_200803.pdf.

[13] Report of the finance committee of the German Bundestag, BT-Drucksache 15/1944, http://www.bundestag.de/parlament/gremien15/a07/Beschlussempfehlungen_und_Berichte__15__Wahlperiode_/1944.pdf, p. 14; Börsen-Zeitung, 08.11.2003 "Investmentgesetz bringt Finanzplatz Deutschland auf richtige Spur"; Börsen-Zeitung, 14.10.2003 "Investmentgesetz droht Eichels Ziel zu verfehlen".

[14] Full statement of the reasons of the draft bill (supra, note 12), p. 153.

[15] *Waldeck/Süßmann*, WM 1993, 361, 363 et sq.; *Lenz/Kopp-Colomb*, Wertpapierverkaufsprospekte, 2001, p. 31 et sqq..; *Hopt*, Die Verantwortlichkeit der Banken bei Emissionen, München 1991, margin-no. 31; *Dittrich*, Die Privatplazierung im deutschen Kapitalmarktrecht, Frankfurt 1998, p. 32 et sqq.

[16] *Dittrich* (supra, note 15), at p. 61.

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of the new InvestG, since there a prospectus is considered necessary even in cases of private placements of hedge fund units. According to the VerkProspG there is a need to create a prospectus in order to provide the necessary information about placements to the investor. Therefore it can be argued that a prospectus is not needed if the investor is well informed or has the possibility to inform himself without protection by law. This does not make sense under the new InvestG. Under the InvestG a prospectus is required even in cases of private placement and therefore the difference of private and public placement cannot be defined by criteria of information of the investor. The InvestG is assumed to prevent private investors from investing in hedge funds.[17] The reason for distinguishing between private and public placements in the VerkProspG is to ensure sufficient information for investors. The reason in the InvestG is to protect or exclude private investors from investing in single hedge funds. Even in the legislation materials of the InvestG it is said that the interdiction of public placements of single hedge funds is to ensure that not all private investors are able to invest in hedge funds.[18]

Private investors in Germany should only get access to hedge funds via a funds of hedge funds. Funds of hedge funds are regulated in sec. 113 InvestG and these are the only funds that are permitted to invest in hedge funds. For other funds this possibility is excluded, even if it may seem useful in a limited way.

The legal conditions for those funds of hedge funds are defined as follows:

Investment restrictions are defined in Sec. 113. Sec. 113 para. 2 restricts the investment in cash assets to 49 per cent. Sec. 113 para. 4 further restricts the investment in one single hedge fund to a maximum of 20 per cent of the fund value and only allows to invest in two funds of the same emitter or fund manager. On the other hand it is possible for a fund of hedge funds to buy all shares of one single hedge fund, while at the same time a fund of hedge funds is not allowed to invest in other funds of hedge funds.

The disinvestment-possibilities for investors in hedge funds or funds of hedge funds are more restricted than these of investors in conventional funds. In hedge funds or funds of hedge funds a disinvestment is not possible every day but can be restricted in the prospectus to certain pre-fixed dates up to once every three months. The disinvestment has to be announced by the investor at least 40 days in advance if he has invested in a single hedge fund, and 100 days in advance if he has

[17] Lang (fn 2), p. 58.

[18] Report of the finance committee of the German Bundestag (supra, note 13), p. 36, states clearly that this should ensure that not all kind of private investors will invest in hedge funds.

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invested in a fund of hedge funds. Thus it is legally recognised that hedge fund and fund of hedge funds investments are no short-term investments, and that the funds are often short of liquid assets because of their investment strategies, so that sudden disinvestment can either cause difficulties or disable them to follow certain strategies.[19] Therefore the necessary solvency for a sudden withdrawal of the investors is not always given.

The simplified prospectus which is now prescribed for other funds is not admissible for single hedge funds and funds of hedge funds. According to sec. 117 para. 2 InvestG the investor has to be warned in the prospectus about the fact that the investment can lead to losses and that even a total loss of the investment is possible. Furthermore additional information has to be included in the prospectus: Firstly the criteria according to which hedge funds are chosen by funds of hedge funds, and secondly the extend to which those hedge funds use leverage or short-selling strategies have to be described in the prospectus. Moreover information of the fee-structure of the chosen hedge funds as well as information concerning the total of fees the investor has to carry, have to be provided. The restrictions of the disinvestment possibilities compared to normal funds have to be mentioned in the prospectus in a highlighted way.

Sec. 120 InvestG requires that persons who are responsible for investment decisions of funds of hedge funds have to have professional experience and practical knowledge about investments in hedge funds.

What remains more or less unchanged in German investment law is the legal link for the application of the investment law. This legal link is still the collective investment with diversified risks organised in a collective investment scheme by a Kapitalanlagegesellschaft (KAG) or by buying shares of an Investmentaktiengesellschaft. This is what could - and what still can - be described as an opt-in-model, and what was already heavily criticised in the past,[20] as it restricted the applicability of the law to organisations that were organised in a certain way and left all other forms of collective investments unregulated.[21] That is the reason why the alternative structures of hedge fund related products described above could be distributed in Germany under the regime of the old KAGG and - as this legal link was kept by the legislator - still can be distributed under the regime of the new InvestG. Therefore, even when putting aside the legislatory reservations about the intellectual

[19] Full statement of the reasons of the draft bill (supra, note 12), p. 209.

[20] Bankrechtshandbuch - *Köndgen* (supra, note 5), Sec. 113, margin no. 34.

[21] Bankrechtshandbuch - *Köndgen*, (supra, note 5) Sec.113, margin no. 34.

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capacity of German private investors, the German regime still has to be described as kind of old-fashioned and the past is still not bygone.

IV. An up-to-date future

The future of the legal framework for the German hedge fund industry will certainly see new changes before too long. This is true because some parts of the problem have been excluded from the new law, e.g. the regulation of private equity funds. Other parts are regulated on a merely national level, e. g real estate funds and hedge funds. Until now they are not part of the UCITS directives[22] or any other European regulation. However, there already is an initiative of the European Parliament to set a legal framework for hedge funds, funds of hedge funds and options on an European level as well.[23] It is true that, legally spoken, the European Parliament has no initiative right. However, the initiative has a political impact and it fits well into the frame of the European Commissions plans of integrating the European financial markets.[24] Especially the member-states hedge fund regulations still appear like a patchwork of different legal solutions. It is easy to imagine that the German hedge fund regulation will have to be adopted to a European solution in the future. The limitation of distribution of hedge funds by private placement only is unlikely to be the result of a future European Directive. For that reason the German opt-in model in the InvestG, once again maintained by the legislator and giving wide possibilities to hedge fund distribution on the so-called grey capital market, can't be maintained forever. This may result in a regulation which even affords the possibility for conventional funds to invest in hedge funds at least up to a certain part.

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[22] Directive 2001/107/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses

http://europa.eu.int/eur-lex/pri/en/oj/dat/2002/l_041/l_04120020213en00200034.pdf

Directive 2001/108/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), with regard to investments of UCITS

http://europa.eu.int/eur-lex/pri/en/oj/dat/2002/l_041/l_04120020213en00350042.pdf.

[23] Börsen-Zeitung, 26.08.2003, "EU-Pass für Hedgefonds - Parlament eröffnet Debatte"; Börsen-Zeitung, 13.01.2004, "Neue Hedgefonds-Allianz bildet sich"; Börsen-Zeitung, 16.01.2004, "EU-Pass für Hedgefonds".

[24] See the European Commissions Action Plan for Financial Services http://europa.eu.int/comm/internal_market/en/finances/actionplan/index.htm#plans.

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The initiative of the European Parliament considers minimum amounts for investments in hedge funds.[25] As the hedge fund industry present on the German market has already developed structured products for investments that have the same economic effect and the same risk as hedge fund investments, German law will have to change, otherwise the European Parliament initiative will not make any sense.

V. Main deficits of the new hedge fund legislation

The new InvestG brings some modernisation for German investment law. For the first time hedge funds are recognised and regulated by the German legislator and even private investors have the possibility of participating in hedge funds via funds of hedge funds. However the German legislator still clings to the old opt-in model, which by providing restrictions in the scope of the laws application opens wide possibilities on the so called "grey capital market" and has not chosen a more economical definition of funds as for example art. 2 of the Swiss Anlagefondsgesetz.[26]

Moreover the German legislator still distrusts the capability of German private investors in making an informed investment decision. For this reason the new single hedge fund regime is still kind of prohibitive for private investors. This seems unnecessary, as even before the new hedge fund regulation there were ways of investing in hedge funds for private investors. It seems even more unnecessary as the hedge fund industry itself is not interested in the investments of small private investors and usually demands minimum amounts of investments, which are only possible for distinguished private investors. As for funds of hedge funds, the investment in those funds is now allowed to all kinds of investors. This is true at least from a legal point of view. From a more practical point of view it is quite possible that even here the investment industry will demand minimum amounts of investments that exclude small private investors from investing in hedge funds. Even here the legislator found it necessary to demand a warning in the prospectus of the fund of hedge funds, indicating that the investment can lead to losses and even to the total loss of the investment.

This warning is kind of irritating. It warns of losses, but losses are possible for many other kinds of investments as well, as many private investors will have experienced in the last years of bear markets. However it is not mandatory to issue warnings in the prospectus in regard to these other investments. This holds true

[25] Börsen-Zeitung, 16.01.2004, "EU-Pass für Hedgefonds".

[26] Swiss Investmentfunds Act (Bundesgesetz über Anlagefonds vom 18.03.1994, Anlagefondsgesetz - "AFG"), for the full text see http://www.gesetze.ch/sr/951.31/951.31_000.htm.

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especially for investments in investment funds, probably the most relevant under the new InvestG, which brings a lot of new possibilities for funds to invest in options or other derivative instruments, which usually include chances for investors but at the same time a lot of risks.[27]

[27] *Lang* (supra, note 2) p. 59.

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