New German Rules for Hedge Funds and Foreign Funds  
– Amended Proposals after Finance Committee Hearing –

The draft German Investment Modernization Act (Investmentmodernisierungsgesetz), originally released by the Federal Ministry of Finance as a discussion draft in early July and adopted (with certain amendments) by the Federal Government in August 2003, has meanwhile been heard in a first reading in the lower chamber of the German parliament (Bundestag) and discussed in the Bundestag’s finance committee. Following the finance committee meeting, the governing coalition’s SPD and Bündnis 90/DIE GRÜNEN parliamentary groups have recently adopted combined proposals for amendments to the draft legislation (the “Proposed Amendments”). It is widely expected that the draft will be approved, and enter into force on January 1, 2004, with most of the Proposed Amendments. Thus, the new legislation has now sufficiently progressed to discuss the draft provisions relating to hedge funds and foreign funds as currently proposed by the governing coalition’s parliamentary groups.

Introduction

The Investment Modernization Act strives to modernize and harmonize the German legal environment for investment funds. In addition, it will combine all regulatory aspects of investment funds in a new Investment Act (Investmentgesetz), and the tax aspects in a new Investment Tax Act (Investmentsteuergesetz), respectively, irrespective of the fund’s domestic or foreign origin. In particular, the new legislation aims at allowing for the first time the establishment of hedge funds in Germany, facilitating the public distribution of foreign hedge funds under conditions comparable to those of German hedge funds, and modernizing the rules governing investment stock corporations (Investmentaktiengesellschaften), including by providing for an open-end investment stock corporation with variable capital similar to a Luxemburg SICAV as an alternative organizational form particularly for hedge funds.

Authorization of Hedge Funds

The current German Investment Companies Act (Gesetz über Kapitalanlagegesellschaften) does not allow German investment management companies (Kapitalanlagegesellschaften) to establish a hedge fund as an investment fund (Sondervermögen), nor may a hedge fund be established as an investment stock corporation. In addition, the tax provisions of the current Foreign Investment Act (Ausland-investment-Gesetz) effectively prevent the public distribution of foreign hedge funds in Germany. The new legislation will, for the first time, permit the establishment of German hedge funds as an investment fund, the so-called investment fund with additional risks (Sondervermögen mit zusätzlichen Risiken), managed by a domestic investment management company, or as an investment stock corporation. In addition, the new legislation amends the regime for foreign funds to the effect that the distribution of foreign hedge funds in Germany be allowed under conditions comparable to those for domestic hedge funds, and removes prior tax impediments to the distribution of foreign funds.

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1 The draft will again be discussed in the finance committee on November 5, and is scheduled for final reading in the Bundestag on November 7 and in the upper chamber (Bundesrat) on November 28, 2003.


3 The concept of an investment stock corporation with investors as stockholders in the fund, long recognized in many other jurisdictions, was introduced in Germany in 1998 as a second organizational form (in addition to an investment fund without legal capacity managed by an investment management company). However, such investment stock corporation rules were largely impracticable and, thus, no such corporation has ever been established.
**German Hedge Funds.** The draft Investment Act contains specific provisions for single manager hedge funds and funds of hedge funds, both of which will, however, also be subject to the general provisions applicable to all investment funds (e.g., contractual terms or articles of incorporation, prospectus, accounting and publication requirements and marketing provisions). Under the new rules, both kinds of hedge funds may generally be established by domestic investment management companies or as investment stock corporations with only a few additional requirements (e.g., due expertise of the asset manager, risk assessment models, and additional inspection rights of the German Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht or BaFin)).

**Single Manager Hedge Funds.** To provide greater flexibility, the draft refrains from setting forth a specific definition of hedge funds. Rather, its single manager hedge fund rules are applicable to all funds that, while adhering to the principle of risk diversification, are not otherwise restricted in the selection of assets within the framework of their investment strategies, provided that the fund’s contractual terms provide for either leverage (through generally unrestricted borrowing or the use of derivatives) and/or the use of short selling.4

In line with the amended EU Investment Directive, the draft abolishes the current classification of statutory fund types. Instead, it lists a catalogue of asset classes generally permissible for all types of investment funds: securities, money market instruments, derivatives, bank deposits, real estate, participations in real estate companies, and investment fund units. Domestic single manager hedge funds and comparable foreign funds are generally allowed to invest in all these asset classes, except that the Proposed Amendments would prohibit them from investing in real estate and participations in real estate companies in order to prevent the current "grey market", unsupervised closed-end real estate funds from using a hedge fund as a means to obtain the favorable tax treatment. In addition, these funds would be permitted to invest in other corporate participations (including German silent partnerships) with a determinable market value, in precious metals and in cash-settled commodity futures traded on a regulated market (direct investment in commodities would still be prohibited). However, the draft provides that the fund’s contractual terms must restrict investments in unlisted private equity to a maximum of 30% of the fund’s assets in order to prevent private equity funds from disguising as hedge funds.

A single manager hedge fund’s net asset value must generally be calculated on a daily basis (but, pursuant to the Proposed Amendments, the contractual terms of the fund may provide that this calculation be performed only as of specific redemption dates), and investors must have the opportunity to redeem their fund units at least once per quarter (with a notice period of up to 40 calendar days). Single manager hedge funds must engage a custodian bank to keep their assets in custody, but individual tasks of the custodian bank may also be performed by a comparable institution, provided it is contractually ensured that the custodian bank is liable for the fault of such institution.

**Funds of Hedge Funds.** Funds of hedge funds under the new rules are funds that invest in target funds (and, in addition, in bank deposits and money-market instruments – up to 49% of the fund’s assets –, and in certain currency-hedging instruments). Permissible target funds comprise German single manager hedge funds (and, pursuant to the Proposed Amendments, German investment stock corporations whose articles provide for comparable investments) as well as foreign funds that, with respect to their investment policy, are subject to requirements comparable to those for German hedge funds and that follow certain organizational regulations. Target funds need not be regulated, but funds in countries that do not cooperate in international efforts against money laundering are barred as investments. Although funds of hedge funds must not engage in leverage or short selling, the underlying target funds may do so.

While the draft legislation was somewhat unclear on diversification requirements, the Proposed Amendments would provide for the following: no more than 20% of the fund’s assets in a single target fund, and only two target funds of the same issuer or fund manager. This is intended to clarify that the fund of hedge funds may also invest in target funds of the same issuer, e.g., within a group, and that the investment strategy is not a criterion for the required diversification. Moreover, while it is permissible for funds of hedge funds to acquire all of the outstanding units of a target fund, the draft prohibits investments in target funds that themselves invest in other funds (i.e., no cascade funds).5

A fund of hedge funds must ensure that it has sufficient information on the target funds, must continuously monitor the target funds with respect to its investment policy and to risks, and must regularly obtain from them generally recognized risk ratios.

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4 The Federal Ministry of Finance is authorized to issue regulations restricting the unlimited use of these techniques to the extent required to prevent market abuse and to protect market integrity.

5 Although this provision was heavily disputed, the Proposed Amendments would not change it.
Fund units must be redeemable at least once per quarter (with a notice period of up to 100 calendar days), and the draft also provides for certain additional information in the prospectus (including information on the target funds and a risk warning; short form prospectuses may not be used). The Proposed Amendments clarify that funds of hedge funds may only acquire foreign target funds if their assets are kept in custody by a custodian bank or a comparable institution (e.g., prime brokers).

**Single Manager Hedge Funds not for Public Distribution.** In light of the broad investment possibilities for single manager hedge funds, the government draft stipulated that they may only be established as institutional buyers’ funds, so-called special funds (Spezial-Sondervermögen), which implied that they could only be held by up to 30 investors, who could not be natural persons. In contrast, while foreign single manager hedge funds could also not have been publicly distributed in Germany, their sale to individuals through a private placement would not have been prohibited. This would have resulted in discrimination against German single manager hedge funds. The Proposed Amendments, therefore, provide that German single manager hedge funds must not be publicly distributed, i.e., private placements to individuals are now allowed for German single manager hedge funds as well.

As a result, and although the regulations of hedge funds in certain jurisdictions may still be more favorable, the hedge fund provisions of the German Investment Modernization Act as so amended should, particularly in connection with the new investment stock corporation rules, generally provide a competitive legal framework for establishing hedge funds in Germany with a view towards the German market. Moreover, the draft legislation also contains provisions designed to smoothen and accelerate the approval process, and we understand that the BaFin is currently implementing respective organizational and personnel measures.

**Public Distribution of Foreign Funds in Germany.** The draft rules governing the distribution of foreign funds in Germany distinguish between UCITS investment funds and non-UCITS investment funds. UCITS funds enjoy the benefit of a product passport under the amended EU UCITS directive. The investment company must notify the BaFin (providing certain documents, including a certificate from the relevant home member state authority as to compliance with the provisions of the UCITS directive) of its intention to publicly distribute the fund units in Germany, appoint at least one German paying and redemption agent and ensure distribution of the required information to investors in Germany. It may then begin public distribution of the UCITS investment fund in Germany upon the lapse of two months from the submission of a complete notification to the BaFin, unless the BaFin prohibits the distribution.

**Non-UCITS Rules Applicable to Foreign Funds of Hedge Funds.** In line with the treatment of German single manager hedge funds, foreign single manager hedge funds may not be publicly distributed in Germany. Foreign funds of hedge funds would have to follow the rules for non-UCITS investment funds to publicly distribute their units or shares in Germany. These rules generally require the investment company to notify the BaFin of its intention to publicly distribute the fund units in Germany (providing documentation that is considerably more comprehensive than for UCITS funds), to appoint a German representative (who would represent it in and out of court and be deemed authorized to receive delivery of documents on behalf of it) and at least one German paying agent, to engage a custodian bank to keep its assets in custody, and to ensure distribution of the required information to investors in Germany. Moreover, the contractual terms or articles of incorporation must meet certain minimum requirements (e.g., right of investors to call for redemption and limitation of prepayment of costs). If all these conditions are met, the investment company may begin public distribution of the non-UCITS investment fund in Germany upon the lapse of three months from the submission of a complete notification to the BaFin, unless the BaFin prohibits the distribution. The draft also provides for certain additional prospectus content requirements and prohibits the use of a short-form prospectus for foreign non-UCITS funds.

Foreign funds that, with respect to their investment policy, are subject to requirements comparable to those applicable to domestic funds of hedge funds, may generally be marketed and sold in Germany under conditions comparable to those for domestic funds of hedge funds. For example, their contractual terms may restrict the redemption of shares to at least once per quarter; they must adhere to publication and marketing provisions similar to those for German funds.

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6 The BaFin has a period of four weeks to either confirm the date of submission of a complete notification or request additional information and/or documentation.

7 Note that these rules do not apply to units or shares in foreign investment funds that are listed on either the official market (Amtlicher Markt) or regulated market (Geregelter Markt) segment of a German exchange, provided they are not publicly marketed (except for any publications required by the relevant exchange).
funds of hedge funds; and they must provide certain additional information in the prospectus. In addition, the Proposed Amendments clarify that foreign funds of hedge funds may only invest in foreign target funds if their assets are held through a custodian bank or comparable institution (e.g., prime brokers).

**Funds from non-EU and non-EEA Countries not Excluded.** The government draft restricted public distribution of non-UCITS funds in Germany to those based in another EU or EEA country, and required a separate ordinance of the Federal Ministry of Finance for other countries (e.g., Swiss, US and offshore funds), which ordinance in turn was subject to certain prerequisites (i.e., effective public supervision in the relevant country and satisfactory co-operation of the relevant regulatory and fiscal authorities). Pursuant to the Proposed Amendments, however, these distribution rules would now be applicable to all foreign non-UCITS funds, provided that the foreign investment company and any investment management company are subject to effective supervision in their respective countries and the relevant supervisory authorities are, in the experience of the BaFin, prepared to cooperate satisfactorily. Moreover, according to the Proposed Amendments, the BaFin could now stipulate for individual countries that, if the provisos in the preceding sentence as well as the requirements of the UCITS directive are met, the distribution in Germany would follow the simple notification rules for UCITS funds.

**Transitional Period for Derivatives Funds.** The Proposed Amendments also contain an important revision for foreign derivatives funds. Given that the new Investment Act will explicitly list derivatives as an asset class available to funds, foreign derivatives funds that thus far were not subject to the German Foreign Investment Act will in future fall under the new rules. Under the government draft this would have meant that any such funds had to immediately terminate public distribution in Germany once the new rules become effective. The Proposed Amendments now provide for a transitional period until the end of 2004 to complete the procedures for non-UCITS funds.

**Taxation of Hedge Funds**

The Investment Tax Act, in the form of the Proposed Amendments, would be applicable as of January 1, 2004 to all funds that qualify as a domestic or foreign investment fund under the Investment Act.

**Investment Funds to be Transparent.** Under the new Investment Tax Act, both domestic as well as foreign investment funds will be transparent for tax purposes and, therefore, exempt from corporate income tax and trade tax in Germany. The investors will principally be treated as if they had invested directly in the fund's assets. Income derived by the investment fund from dividends and from profits from the sale of shares in corporations will be treated tax favorably at the investor’s level. In contrast to the treatment under the Investment Companies Act and the Foreign Investment Act, profits realized by the fund from forward contracts (Termingeschäfte) are not subject to tax at the private investors' level. Even though an investment fund is transparent for tax purposes, loss carry-forwards will only be recognized at the level of the investment fund.

**Reporting Requirements.** The draft Investment Tax Act stipulates detailed reporting requirements to be met by the investment fund to qualify its income for the favorable tax treatment. Pursuant to the Proposed Amendments, if the fund fails to provide certain information itemizing distributed earnings or concerning the amount of certain foreign taxes attributable to distributed earnings and deemed distributions, the income from the investment fund would not be eligible for the favorable tax treatment; a penalty tax (i.e., the income derived from the fund units would be deemed to consist of the fund’s distributions plus 70% of the increase in the unit’s redemption price in the calendar year, but at least 6% of the redemption price last quoted in the calendar year) would only be triggered if any of the other reporting requirements is not met. As a consequence, the scope of the penalty tax will be limited considerably.

The reporting requirements for funds of hedge funds also include information regarding all the target funds. Under the Proposed Amendments, failure to provide such information regarding a target fund would trigger the penalty tax with respect to income from such target fund. The remaining income derived by the fund of hedge funds would, however, still be eligible for the favorable tax treatment.

**Calculation of Interim Profits Abolished.** Contrary to the Investment Companies Act and Foreign Investment Act, the new Investment Tax Act would not require calculation of interim profits (i.e., the net interim earnings contained in the net asset value of a fund unit). On the one hand, this means that the interim profits do no longer trigger taxable income at the transfer or redemption of a fund unit; on the other hand, however, interim profits paid at the acquisition of a fund unit may no longer be deducted by the investor as negative income.
Taxation of Investors at Sale or Redemption of Fund Units. In the case of private investors, income realized at the sale or redemption of fund units within a period of one year after their acquisition is subject to taxation by half to the extent such income relates to dividends and profits from the sale of shares in corporations; after such one-year period this income is tax exempt. In case of corporate investors, income realized at the sale or redemption of fund units is principally subject to taxation. However, income attributable to the fund units is fully tax exempt to the extent it relates to dividends or profits from the sale of shares in corporations.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For more information on the topics covered in this issue, please contact:

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