

Germany strides into hedge funds



PROMOTING FRANKFURT: Germany must offer hedge fund managers a real choice

The 2004 Investment Act allowed hedge funds either to open as part of an investment company (KAG) or as an open-ended vehicle with less regulatory, reporting and capital requirements. How attractive have these been?

Robert Welzel (RW): Compared to the former fund regulatory law, a large step in the right direction has been taken. Uncertainties in the new fund regulatory law and the attractiveness of the well-established onshore centers, such as Dublin, have slowed the success of German-domiciled hedge funds. German tax law or German investors have not been a cause of the slow development of German-domiciled hedge funds.

Claude Noesen (CN): The law is quite liberal and should have attracted much more interest. While the KAG model had

some success, the Investment AG was not successful at all. One of the major reasons was that umbrella structures, which contributed to the success of the competing Luxembourg vehicle, are not allowed in Germany law.

Some industry participants expected the German hedge fund and fund of hedge fund industry to grow very quickly to levels that were estimated to be between €6bn and €60bn. Up to June 2006, approximately €1bn has poured into 20 domestic German hedge funds distributed by a dozen fund companies. The fund of hedge fund industry is coping with a number of technical issues such as the prohibition of liquidity lines, a definite show stopper in this area, or the absence of a decent empire of tax transparent single manager hedge funds on a global basis.

So far, fewer than 20 domestic funds of hedge funds (FoHFs) have launched and have attracted less than half a billion in managed assets. Some promoters simply chose the easier Luxembourg route with a dozen launched vehicles attracting close to €1bn in managed assets.

However, one should not forget that the big success in Germany still comes from certificates, which amount to roughly €20bn and is controlled by the very large banks. Certificates might be more expensive than straightforward products, but they have proved to be the vehicle of choice in Germany.

The shadow that originally overcast the entire industry was the tax transparency requirement for those funds that wanted to distribute in Germany. This was something that was taken somewhat lightheartedly by many participants as they believed that someone who can deliver tax transparency for traditional long-only products can do the same for complex hedge fund strategies by simply turning on a switch.

This was not the case and the development of the transparency functionality for an administrator such as HSBC Securities Services took a lot of foresight, planning and sector knowledge throughout its development path.

As these tax transparency requirements will not go away with the imminent revision of the law, HSBC is uniquely placed to service the German domestic market and any offshore fund that wishes to distribute in Germany or to a FoHF seeking tax transparent funds for investment.

What is the attitude of the industry towards the KAG requirement? What are its benefits and disadvantages?

CN: In principle, German-domiciled hedge funds can only be launched and sold by a KAG, which on paper is the acting investment manager. It can delegate the investment advisory function though and it will act as administrator for the fund. At the same time it will liaise with the regulator as well as be responsible for the risk management function which is one of the main concerns to the regulator.

GERMAN ROUNDTABLE

In addition to a number of administrative functions that are traditionally performed by the administrator, it will write the prospectus and calculate the G-tax figures. What is more cumbersome and what has been proposed to be abolished in the next version of the investment law, is the necessity of a Depotbank that provides a number of functions, including the custodian function. In the existing law, it can appoint a sub-custodian, usually the prime broker.

For HSBC, the existing solution poses no major problem as we have all pieces in place through INKA, which is our Duesseldorf-based KAG as well as HSBC Trinkaus & Burkhardt which assumes the Depotbank part in the equation. However, should the law be revised in a way that the Depotbank will not need to remain in place for a single manager fund, the equation would be much easier and probably less expensive than today.

RW: The KAG model is not a standard model, compared to the international hedge fund structures. The benefit is that it is very well known to German investors.

Has the political climate in Germany warmed to hedge funds since they were cast in a poor light by the secretary-general of the SDP earlier in 2006?

RW: As far as we can judge, the term 'locust' was geared more towards some private equity funds and funds focussing on German apartment buildings than towards hedge funds following a classic investment strategy. There is a general discussion in Germany on whether and how to try to regulate hedge funds and to achieve transparency.

CN: I personally don't think so. While the ministry of finance (BMF) looks positively on hedge funds, the locust story has not gone away and discussions about regulation of hedge funds will continue for the foreseeable future. We sometimes forget that we are already in a mode that is heavily moving towards convergence of traditional and alternative asset classes. Already today, some UCITS 3 products resemble mini-hedge funds that use derivatives extensively.

Is the Investment Act 2004 viewed as too prescriptive on foreign hedge funds?

CN: No, not at all. The Investment Act itself has not been prescriptive on foreign hedge funds in any way. Distribution via private placement for domestic and foreign hedge funds is not a problem.

A number of issues with respect to single manager hedge funds and FoHF had some negative influence on the success, but were not really show stoppers. These issues have now been brought by the



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industry to the attention of the BMF in the latest draft of revisions that is expected to be approved in early 2007. This draft contains a number of issues that will make life easier for managers, service providers and investors.

In the first stage, the main issue was tax transparency and that has gone away now with a handful of administrators being able to deliver this transparency at a reasonable cost.

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Claude Noesen, HSBC Security Services

An important issue for the fund manager to be aware of is that the resulting tax certificate does not imply the publication of the underlying positions, such as the disclosure of the strategy. It merely shows tax numbers on the nature of income streams.

Through all our jurisdictions where we provide administration services for hedge funds, we run into requests for G-tax on a nearly daily basis. Our New York tax-centre, provides these G-tax calculations provides this service to some 30 funds and managed accounts as we speak. The numbers are increasing by the week, which is a good sign for the market as the institutional market finally seems to be opening up to the alternative space.

RW: The Investment Act 2004 does not forbid the investment into non-German hedge funds in any way. It only regulates

the public distribution of such funds, such as on a private placement basis a single hedge fund can be sold into Germany without further complications. Also, life insurers are allowed to invest a substantial portion of the committed assets into hedge funds. From a tax perspective, German and non-German hedge funds are on a level playing field. Moreover, the investment via hedge funds is in most cases more tax beneficial than a direct investment into the assets.

Private equity and property funds have proved very popular in Germany. Does the potential exist for hedge funds to reach the same status?

RW: In the medium term yes. In the past, hedge funds were a largely unknown investment product in Germany and regulated investors like insurers faced severe restrictions. Also, the former German tax law discriminated against hedge funds. With regard to hedge funds and their effect on portfolio diversification, many Germans are illiterate, at present. If the structure of German portfolios is likely to resemble the portfolio of investors in other developed countries in the future, then German (institutional/private) investors will invest a significantly larger percentage of their assets into hedge funds. PwC recently notices an increase of the flow of money into hedge funds by institutional investors.

CN: This is difficult to say as a lot of damage has been done in the past, not least by the locust story. Germany has traditionally been a very conservative and careful country from an investment management point of view. Remember that Germany has one of the highest savings rates in the world. Any negative event such as the domestic Phoenix Kapitaldienst disaster or Amaranth is immediately picked up by the press and even used by the politicians to display their negative views.

The strange thing that always puzzled me about Germany in this respect is that not only private equity or real estate proves very popular albeit it carries risks as well. They manage to wrap almost anything into funds, from windfarms to container ships to movies, and even though these investments can carry substantial risk, the sale usually works. Once the market has further adopted the hedge fund as presentable or 'salonfaehig', it will have a reasonable success. It is just a matter of time until investors feel more familiar and comfortable with hedge funds and making hedge funds a viable diversification component of German investment portfolios.

Will the uptake in local structured hedge funds increase or will the German market remain dominated by foreign funds?

CN: One has to look at this over time. It is

almost logical that offshore single manager funds will carry the lead in the beginning as they will be the ones who have the expertise in the run-up to a German industry coming into existence. These offshore funds will often seek tax-transparency for being eligible to be invested into by German FoHF, or even Luxembourg or Irish FoHF that are eligible for distribution into Germany, as those are the centres where the service provider expertise sits at the moment. That will be the first move we will see.

The second wave will be more domestic in nature, certainly because German domestic managers will start popping up on the hedge fund scene. German traders have always had a good image, they have traditionally been strong in arbitrage situations, but they have remained shy.

Prop traders in the US or England found it traditionally easier than their German peers to leave the large investment banks in order to join a hedge fund. This might change in the future. I personally believe the German market will take a reasonable share but foreign funds will continue to dominate. Don't forget many German funds get launched via Luxembourg by German institutions, such as the term 'Deutsche Provenienz'.

RW: The market will remain dominated by non-German hedge funds for quite a while because it is not easy to make up for years of lost time in developing this industry. However, I believe that there is room for a German hedge fund industry, too, because some German investors tend towards German domiciled vehicles. Especially the not-so-sophisticated regulated investors (such as smaller insurance companies) will probably look to German KAGs to provide them with a suitable product and the necessary supplementary services.

With the KAG acting in law as the asset manager, will more service providers move into Germany to offer a one-stop service?

RW: Yes, PwC sees a movement by some hedge fund promoters to consider setting up their own KAG in Germany or to have their hedge funds white labelled via a German domiciled Master-KAG. The latter is probably the more promising route in the short term. Setting up one's own KAG does take time and assets under management. In addition, PwC envisages that the set-up of the German domiciled asset management industry will change significantly. In the past, the industry was based on a full service concept, such as the KAG provided all services inhouse, like asset allocation, risk management, shareholder record keeping and fund administration. There is a trend towards a break-up of the value chain under which

external (non-German) providers deliver their services to the KAGs. In this respect, PwC anticipates good opportunities for specialized hedge fund administrators.

CN: A clear 'no' here for the moment. As with custodians, we are likely to see consolidation in KAGs as they are pushed by their respective boards to decide whether to focus on investment management or look at administration only. In line with the entire European area, there will be major consolidation within the transaction-banking sector in Germany. While larger institutions will be aiming to provide payment and securities services, the smaller transactions banks will have to focus on one of the two services or face a lift-out situation in the near future.

Master-KAG services are being offered by a handful of specialised firms and that trend will continue. We do not see massive moves by international service providers into Germany. We instead see hub-and-spoke models such as the HSBC one emerging where a number of functions can be provided out of the global centres of excellence such as Luxembourg or Dublin while only a minor part (the 'regulatory part') will be provided by the German-based spokes. This is the name of the game of globalisation within the securities services industry and will be definitely true for Germany until the market reaches a level that would justify such large and expensive moves.

On the prime brokerage front, we also do not believe that the prime brokers will move into Germany directly with large set-ups as that part of the business is currently being covered by the London financial centre for the whole of continental Europe and that situation is unlikely to change. Depending on the appetite of German based specialist managers, one might see sales people based in Germany, another function that will be driven out of London until such time when the single-manager market will reach a critical mass.

So far at least, the success of foreign service-providers that have set-up in Germany has remained extremely minimal, but this does not say that they won't be successful in the future as the business expands.

For Germany to attract more hedge funds in the future, what changes, on a regulatory, infrastructure or service provision level, need to happen?

CN: Regulatory-wise, a number of changes and improvements have been recommended to the BMF and are expected to become part of the revised law early 2007. These changes will have a positive influence on the entire industry such as managers, promoters, investors and service providers.

Some of the main issues that have been proposed are the following:



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- No investment restrictions on single manager funds (except investments into real estate)
 - The dropping of the Depot (custodian) – Bank concept, paving the way to the pure administrator
 - Resolution of the prime broker-related problems on close out netting contracts
 - The introduction of a 10% liquidity line for FoHF
 - The abolition of the cascade regulation
 - For investors, (insurance industry) the increase of the investment limit from 5% to 10% in the case of FoHF and from 1% to 3% for single manager hedge funds
 - In the case of a FoHF redemption, the extension to 50 days for repayment (before three to five days which were technically impossible)
 - The possibility to subscribe to hedge funds via the internet which was not possible so far and should facilitate the subscription process
 - The introduction of 'gates' so that in the case where a fund experiences 15% redemptions, those can be dragged out to the next liquidity date.
- RW:** For hedge funds to be produced in Germany on a larger scale, the German-domiciled KAGs need to offer a sophisticated platform that is able to compete with EU onshore centers, offering a hedge fund manager a true choice between Dublin, Luxembourg and Frankfurt/M. Also, the fund regulatory and tax regime needs to support the German industry by adapting to international flexibility, for example on the eligibility of new asset classes, clear legal guidance on liability within the KAG model and on the laws applicable to the German SICAV. For example, non-eligible assets will cause a different and often disadvantageous tax regime than eligible assets, which is often an issue for credit-related investments. ■