



German Investment Act – BaFin issues new guidelines on the principle of risk diversification

The German Federal Financial Services Authority has set out new guidelines on the principle of risk diversification (*Grundsatz der Risikomischung*), which have to be complied with by collective investment schemes if they are to qualify as investment funds for German regulatory and tax purposes. This briefing summarises the new guidance, highlighting possible areas of uncertainty.

On 28 July 2009 the German Federal Financial Services Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin) set out new guidelines on the principle of risk diversification (*Grundsatz der Risikomischung*). German or foreign collective investment schemes have to comply with the principle of risk diversification to qualify as investment funds for German regulatory and tax purposes. In its new guidelines, BaFin comes to the conclusion that the principle of risk diversification comprises a quantitative and a qualitative element. BaFin is going to clarify at Committee of European Securities Regulators (CESR) level whether other EU member states also recognise the qualitative element. Subject to the outcome of that inquiry, BaFin has reserved the right to change its new guidelines, which were issued in response to requests for the authorisation of several funds related to the price of physical gold.

Principle of risk diversification – general aspects

The principle of risk diversification is set out in section 1 of the German Investment Act (Investmentgesetz – InvG) as a general requirement for the qualification of a collective investment scheme as an investment fund. The InvG does not further define the principle of risk diversification. However, with regard to certain types of German investment funds the InvG provides for different specific quantitative investment limits.

According to BaFin the principle of risk diversification applies to all types of investment funds under the InvG and has to be interpreted in the same way for all types of

funds (eg UCITS funds, non-UCITS funds, special funds, foreign funds, domestic funds). Moreover, BaFin takes the view that the principle of risk diversification applies in addition to the specific quantitative investment limits for certain types of investment funds, which are set out in the special rules of the InvG.

In this respect BaFin now sets out a two-step approach: as a first step the requirements of the principle of risk diversification have to be complied with for a fund to qualify as an investment fund and, only as a second step, compliance with specific quantitative investment limits for the relevant fund type has to be ensured. Consequently, compliance with the specific quantitative investment limits alone is not considered sufficient to comply with the principle of risk diversification. According to the quantitative element as set out by BaFin, investment funds have to be invested in four or more assets. The qualitative element will generally be fulfilled if the four or more assets are subject to different investment risks.

However, BaFin may consider investment funds that comply with the aforementioned rules as insufficiently risk diversified if there are significant quantitative risk concentrations in the investment fund. According to BaFin, this will be the case if the investment fund's performance primarily depends on only one or two assets (eg 50 per cent of the total fund value is invested in stock A, 49 per cent in stock B and the remaining 1 per cent in stocks C and D). In this respect, BaFin proposes the following rule: the fewer assets in a fund, the smaller the difference in weightings of each single asset.

Furthermore, BaFin will consider an investment fund to be insufficiently risk diversified if the weighting of one single asset or one single investment risk amounts to 50 per cent of the total fund value or more. In this context BaFin may consider two or more assets as representing a single investment risk (eg if an investment fund is invested in physical gold and 1:1-certificates based on the price of physical gold).

Principle of risk diversification – exceptions

BaFin points out that both the InvG and its administrative practice allow certain funds to comply only with either the quantitative or the qualitative element of the principle of risk diversification.

Single-issuer funds – UCITS

A statutory exception refers to so-called ‘single-issuer funds’. Under article 23 of the UCITS Directive the EU member states may authorise UCITS to invest up to 100 per cent of their assets in different transferable securities and money market instruments issued or guaranteed by any EU member state, its local authorities, a non-member state or public international bodies of which one or more EU member states are members. However, even if these single-issuer funds do not have to comply with the quantitative element of the principle of risk diversification, the UCITS Directive requires a single-issuer fund to hold securities from at least six different issues and that securities from any one issue may not account for more than 30 per cent of its total assets. BaFin points out that the rules on single-issuer funds are exceptional and that they cannot be applied *mutatis mutandis* to other investment funds.

Sector and country funds

With regard to sector and country funds, BaFin holds the view that they require a modification of the principle of risk diversification. In BaFin’s own words, ‘a limited principle of risk diversification’ is sufficient. Unfortunately, BaFin has not defined what a ‘limited principle of risk diversification’ means, but sets out only two examples.

The first example refers to an automotive sector equity fund. Provided that the quantitative element is fulfilled, it is considered sufficient for the qualitative element that the shares of various automotive companies constitute a similar, but not the same, market risk.

The second example refers to an equity fund investing in several gold mines. Again, BaFin assumes compliance with the qualitative element of the principle of risk diversification, because the profit generated by gold mines does not depend only on the market price of physical gold but on additional other factors.

Cash funds

According to the InvG, cash funds can be set up that invest exclusively in bank deposits. The InvG provides for a specific quantitative investment limit according to which a cash fund may invest not more than 20 per cent of its assets in bank deposits with the same bank.

BaFin points out that it does not require compliance with any qualitative element in addition to these quantitative investment limits with regard to the principle of risk diversification because bank deposits do not entail the risk of a substantial loss of value.

Moreover, BaFin mentions that cash funds in fact do also apply a qualitative element of risk diversification because their deposits with various banks differ with regard to term and interest. However, we do not expect BaFin to require cash funds to invest in deposits with different terms and interest rates.

Consequences of violating the principle of risk diversification

In its general explanations on the principle of risk diversification, BaFin mentions that an investment fund that does not comply with the principle of risk diversification does not fall within the scope of the InvG. This statement could be understood to mean that investment funds that cease to be sufficiently risk diversified at a certain point in time will fall outside the scope of the InvG.

However, we doubt that BaFin really intends to take this position. There is a common understanding in the investment industry that the question whether a collective investment scheme is sufficiently risk diversified to qualify as an investment fund is determined on the basis of the investment goals described in the fund documentation. If an investment fund ceased to be sufficiently risk diversified, it would therefore not fall outside the scope of the InvG but rather such lack of risk diversification would constitute a violation of investment law rules, which may be sanctioned by BaFin.

Summary of BaFin's new guidelines

- Generally, the principle of risk diversification has to be interpreted in the same way for all types of funds (UCITS, non-UCITS, foreign funds, domestic funds, special funds).
- The principle of risk diversification is fulfilled if a collective investment scheme invests in more than three eligible assets ('quantitative element') that have different investment risks ('qualitative element').
- Different investment risks can derive from the type of securities; the issuers' credit ratings; market risks; sales markets; domestic, international or other regional circumstances; currency risks; or income opportunities and maturities.
- Even if a collective investment scheme is formally invested in more than three eligible assets with different investment risks, the risk diversification has to be denied in certain special cases: if an investment fund holds only a small number of assets, the relative weight of these assets must not differ substantially to comply with the quantitative element. The qualitative element is not fulfilled if the overall performance of the investment fund is excessively affected by one single asset or one single investment risk. An excessive effect is, as a rule, assumed if the investment in one asset or one investment risk exceeds 50 to 60 per cent of the total fund value.

- The limitation of single investment risks to a range of 50 to 60 per cent of the total fund value is arbitrary and has no legal basis in the UCITS Directive or the InvG.
- BaFin does not address scenarios in which the return on assets in the investment fund is subject to a total return swap.

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Critical aspects

- BaFin's new guidance is set out in a letter to the German Investment and Asset Management Association (Bundesverband Investment und Asset Management e.V. – BVI). Although many representatives of the German fund industry are members of the BVI, it would have been preferable if BaFin had disclosed its new guidelines to the public because it also has an effect on the qualification of foreign funds as investment funds falling in the scope of the InvG, if these foreign funds shall be distributed in Germany.
- The InvG does not mention a qualitative element of the principle of risk diversification.
- The newly introduced qualitative element and the various carve-outs set out by BaFin will cause legal uncertainty.