

Client Alert

German Funds Practice Group

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The Alternative Investment Fund Managers Directive— Implementation in Germany

Following up on our Client Alert as of 18 February 2014 which covered the implications the EU Alternative Investment Fund Managers Directive (AIFMD) will have on US fund managers in general, this Client Alert sets out the essentials of the implementation of the AIFMD in Germany. Such implementation was conducted by way of introduction of the German Capital Investment Act (*Kapitalanlagegesetzbuch*, “KAGB”) on 22 July 2013.

Open-ended and closed-ended AIFs

In line with a previous recommendation of the European Securities and Market Authority (ESMA) to the European Commission issued in April 2013, the KAGB distinguishes between open and closed-ended AIFs (Alternative Investments Funds), whereas open-ended AIFs are defined as funds where the investors may exercise redemption rights at least once a year, and closed-ended AIFs are defined as all other funds. The European Commission has objected to such approach and by way of a EU regulation has defined AIFs established under the new regime, hence after 22 July 2013, as open in the event that investors are granted *any* redemption rights prior to the beginning of the liquidation period of the AIF. All other AIFs are defined as being closed. Such regulation immediately supersedes any provisions in the KAGB stipulating another differentiation between open-ended and closed-ended AIFs. The German legislator has already announced that it will amend the KAGB shortly inter alia to realign German and European law in this respect.

General Principles of the KAGB

The German legislator has decided not to merely transform the minimum requirements of the AIFMD into national law, but rather to take the opportunity to restructure the regulatory provisions regarding funds in their entirety and introduce a single code which in essence contains all applicable regulatory provisions regarding investment funds, i.e. the KAGB. A private placement of funds has been abandoned entirely, safe for transition periods granted by the German legislator.

The KAGB does not only govern the administration and marketing of funds aimed at being distributed to professional investors, as required by the AIFMD, but also contains regulatory provisions for retail investors. Namely, apart from differentiating between open-ended and closed ended funds, the KAGB distinguished between so-called special AIFs (aimed at

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being distributed solely to professional and semi-professional investors) and public AIFs (aimed at being distributed to any type of investor, including retail investors).

While professional investors are expressly referred to in the AIFMD and comprise—simply speaking—financial institutions, the class of semi-professional investors was only created upon the introduction of the KAGB and covers any investor (including private individuals) willing to commit either (1) at least EUR 10 mio. to a certain fund or (2) at least EUR 200,000 and the AIFM has scrutinized and confirmed that such investor has the experience required to make that certain investment decision and understands the corresponding risks and the AIFM has determined that such investment decision is appropriate considering the individual investor.

Even though the regulatory provisions regarding the marketing of special AIFs and public AIFs are in principle similar, the KAGB in many instances provides stricter requirements regarding the marketing of the latter, as the German legislator assumes that private individuals need a higher level of protection regarding their investments made.

Furthermore, the KAGB stipulates that only certain defined vehicles are eligible to constitute German closed-ended and open-ended AIFs, respectively. Namely, for open-ended AIFs fund initiator may choose between (1) a special form of German limited liability partnership (*offene Investmentkommanditgesellschaft*), (2) a special form of stock corporation (*Investmentaktiengesellschaft mit variablem Kapital*) and (3) pooling the AIF's assets without using a corporate structure (*Sondervermögen*). For closed-ended AIFs, fund initiators may only chose between (1) a special form of limited liability partnership (*geschlossene Investmentkommanditgesellschaft*) or (2) a special form of stock corporation (*Investmentaktiengesellschaft mit fixem Kapital*). Furthermore, the asset class in which an AIF invests may further limit the options of the fund initiator. E.g. in the event of real estate funds, only closed-ended AIFs or open-ended AIFs in the form of a "Sondervermögen" are permissible. Regulatory requirements vary between investment vehicles, e.g. the leverage permissible varies from as low as 30 % of the market value of the assets of the AIF to being unlimited in principle, but subject to scrutiny by the Germany supervisory authority (*Bundesanstalt für Finanzdienstleistung*, "BaFin").

Grandfathering provisions regarding marketing of non EEA AIFs

During a transition period until 21 July 2014, the KAGB provides for grandfathering provisions which allow non EEA AIFMs to market non EEA AIFs in Germany without having to comply with the new regulatory provisions.

Simply speaking, both open-ended and closed-ended non EEA AIFs are privileged in case they have been incorporated and administered prior to 22 July 2013 and marketing of such AIFs was permissible in Germany prior to such date. It is not yet clear from the wording of the relevant provisions of the KAGB and remains to be confirmed by the relevant authorities whether the grandfathering provisions regarding closed-ended AIFs may be interpreted even more extensively.

The right to market funds in accordance with the relevant grandfathering provisions ceases (1) once the application process for distribution with BaFin has been finalized and (2) in any event on 21 July 2014. As the time periods set out in KAGB for scrutiny of an application for marketing of AIFs by BaFin are extensive (they may extend to several months) it is vital to start the application process in a timely manner. In the event that no approval by BaFin regarding the distribution of a certain AIF has been gathered by 21 July 2014, the marketing process needs to be stopped.

Marketing of non EEA AIFs in Germany after lapse of grandfathering provisions

As set out in our client alert as of 18 February 2014, upon the implementation of the AIFMD EEA AIFM authorized in any EEA member state may freely market AIFs across the EEA without the need to gather approvals from all

national regulatory authorities (“EEA passport”). It is envisaged that the same will become possible for non EEA AIFM with respect to the marketing of non EEA AIF after a second wave of implementation from around 2016 (“non EEA passport”), but that is dependent upon the outcome of further deliberations by the EU regulatory bodies.

In the meantime, German law provides for the possibility to distribute non EEA AIFs locally in Germany. However, this is not feasible via private placement but rather under a regulatory regime that is relatively similar to the requirements of AIFMD. Namely, it is possible to market special non EEA AIFs until the introduction of the non EEA passport if:

- the non EEA AIFM complies with the general information requirements vis-à-vis the regulatory authority in Germany set out in the KAGB
- the non EEA AIFM has appointed a depository (*Verwahrstelle*) which supervises the orderly administration of the AIFs under management
- the non EEA AIFM complies with the general information requirements vis-à-vis (potential) investors being applicable (1) prior to the investors making an investment and (2) continuously after making such investment
- appropriate cooperation arrangements are in place between BaFin and the relevant regulators/supervisory authorities of the countries of establishment of the AIFs and the AIFM;
- the country of establishment of the AIF and the AIFM is not listed by the Financial Action Task Force as a Non Cooperative Country and Territory; and
- appropriate measures have been taken to prevent the marketing of the AIFa to retail investors.

In the event that non EEA AIFs are not only marketed to professional, but also to semi-professional investors in Germany, requirements are substantially more comprehensive as it is mandatory that the establishment of the non EEA AIFM and the administration of the AIFs marketed is in compliance with all requirements set out in the AIFMD.

Marketing of special non EEA AIFs is subject to the non EEA AIFM issuing a corresponding notification to BaFin and BaFin approving such marketing. Such application needs to include various written information material regarding both the AIFM, the AIFs themselves and the administration of such AIFs by the AIFM.

Irrespective of the future introduction of the non EEA passport it is possible for non EEA AIFM as of the introduction of the KAGB to locally market non EEA AIFs to retail investors in Germany. However, regulatory restrictions are rather strict and the requirements regarding the documentation to be provided to BaFin in the corresponding application process are comprehensive in order to protect the interest of retail investors.

Permissible Fund Structures

It appears to be worth mentioning that cross-border fund structure are in principle permissible under the KAGB. Hence, it is possible for non EEA AIFM to administer EEA AIF and vice versa. US fund managers may therefore e.g. chose to set up their fund manager in the US because the resources required to conduct such administration are located there, but establish the funds itself within the EEA e.g. to benefit from favorable tax provisions. However, while it is possible to conduct cross-border administration regarding AIFs, marketing of such AIFs may not be permissible in all cases. E.g. this is the case with non EEA AIFM administrating German AIFs. KAGB does not

provide for corresponding provisions regarding the marketing of such AIFs in Germany. Consequently, the exercise of fund formation will become an even more challenging exercise in the event that distribution of units to German investors is intended, and various aspects including location of available resources, tax provisions in the jurisdictions involved and German regulatory requirements will need to be taken into consideration.

Tax Provisions

On 23 December 2013, after longer discussions updated investment tax law supplementing the introduction of the KAGB has come into effect (Act on the Adjustment of the German Investment Tax Act and Other Acts to the AIFM Implementation Act, “**Investment Tax Law Act**”). The single most important distinction to be made under the Investment Tax Law Act is the one between investment funds (*Investmentfonds*, which are tax privileged in terms of the application of the special investment tax provisions) and investment companies (*Investitionsgesellschaften*, which are subject to the general German taxation schemes rather than being privileged under the amended Investment Tax Law Act). To qualify for an investment fund, an AIF needs to fulfill the particular requirements of sec. 1 para 1b of the Investment Tax Law Act, which – in fact - is only feasible in the event of an open-ended fund (see above in this respect) which observes a multitude of investment restrictions. Investment companies need to be divided into further sub-categories to determine the application of the general taxation scheme because the Investment Tax Law Act distinguishes between corporate-like investment companies (*Kapital- Investitionsgesellschaften*) and partnership-like investment companies (*Personen-Investitionsgesellschaften*), depending on the legal/corporate form of the respective AIF. Corporate investment schemes (*Sondervermögen*) which do not form a separate legal entity are deemed to be corporate-like investment companies with certain restrictions in terms of the taxation of dividend payments at the level of the investors or shareholders that need to be assessed on a case-by-case analysis.

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