DechertOnPoint

August 2012 / Special Alert

A legal update from Dechert's Financial Services Group

In this Issue

p1 Introduction

p3 Hedge Funds

p4 Private Equity Funds

p6 (Open-ended) Real Estate Funds

p7 Closed-ended Real Asset Funds (Closed-ended Mutual Fund AIFs, Special Investor Fund AIFs)

p8 Investment Limited Partnership (Pension Pooling)

p9 Investment Stock Corporations

p10 Marketing of Funds

p11 Licensing Issues (Especially Outsourcing)

The German Implementing Act for the AIFM Directive: A Critical Survey of the Draft Bill

Introduction

Implementation of the AIFM Directive: Approach Taken by the German Legislature

Legal Basis

The German Ministry of Finance (BMF) on 20 July 2012 published the draft of a bill (Draft AIFM-Act) to implement the Directive 2011/61/EU on Alternative Investment Fund Managers (AIFMD) into German law. Within the framework of implementing the AIFMD, the Draft AIFM Act provides, in particular, for the repeal of the German Investment Act (*Investmentgesetz* – InvA), which implemented the UCITS Directive 2009/65/EC (UCITSD) among other things. In addition, 26 other acts and regulations have also been amended and/or adjusted. To replace the InvA, which is being repealed, the draft provides for the creation of the "German Investment Code" (*Kapitalanlagegesetzbuch* – GIC), which will comprise the future legal framework for all investment funds in Germany. The AIFMD, which took effect on 21 July 2011, must be implemented into national law by 22 July 2013. Numerous provisions in the draft of the GIC refer to the implementing Regulation for the AIFMD (version of July 2012) (AIFMR), previously only existing in draft form.

Various provisions of the draft GIC distinguish between funds that only allow for non-individual investors, so-called "Special Investor Funds" (*Spezialfonds*), and funds that also allow for individual investors (Mutual Funds).

Approach Taken by the German Legislature

In principle, the draft for the GIC aims at a one-to-one transposition of the AIFMD. This means that the provisions of the AIFMD should be incorporated into German law unchanged to the greatest extent possible. On several points, however, the BMF has gone beyond the mandatory minimum requirements of the AIFMD and imposed a more stringent legal framework on the German investment fund sector than that stipulated by the European legislature. Thus, for instance, the AIFMD only provides for a registration and reporting requirement for funds of small volume. According to the draft of the GIC, the GIC will also apply to these 'small' funds in full. The BMF cites a greater interest in investor protection as the motivation for this.

Repeal of the German Investment Act: Planned Changes

To a large degree, the provisions of the InvA, which is being repealed, shall be carried over to the draft of the GIC. A considerable number of the existing types of investment funds from the InvA shall be retained. However, structural changes will be made to the open-ended special real estate funds (*Immobilien-Sondervermögen*) and infrastructure funds (*Infrastruktur-Sondervermögen*). Both fund types shall only be permitted as closed-ended funds in the future. The fund types of employee participation funds (*Mitarbeiterbeteiligungs-Sondervermögen*) and old-age pension funds (*Altersvorsorge-Sondervermögen*) are being abolished entirely.

Dechert LLP

Scope of Application: Investment Fund by Substance

In determining the scope of the new regulations, the draft abandons the approach of 'investment fund by form', which was used in the past, and replaces it with 'investment fund by substance', corresponding to the AIFMD. According to the approach of 'investment fund by form', all undertakings for collective investment bringing together capital from multiple investors, in order to invest it in the investors' interests according to a set investment strategy, qualified as funds provided that they meet the requirements of the InvA. If a fund did not meet these requirements, it could still have been permissible under a different Act. This will change with the transposition of the AIFMD and the associated introduction of the concept of an 'investment fund by substance'. In the future, a collective investment shall qualify either as an investment fund according to the UCITSD (a UCITS Fund) or as an Alternative Investment Fund (AIF) according to the AIFMD and its relevant implementation into German law. Other fund types will no longer be permitted.

Changes for Management Companies

Changes are also being made with regard to management companies. According to the draft of the GIC, the former term 'investment company' (*Kapitalanlagegesellschaft*) will be replaced by the term of 'asset management company' (*Kapitalverwaltungsgesellschaft* or KVG). Permission to operate a KVG depends on the types of investment funds to be managed by the KVG. AIF KVGs and UCITS KVGs have different licence requirements. If a KVG has both licences, it may manage both UCITS Funds and AIFs at the same time. In addition to this, according to the draft of the GIC, a distinction will be made between internal and external KVGs. A KVG is internal if the fund and the fund management are identical. A KVG is external if it has been retained by an investment fund to provide management.

General Introduction of the Three-Parties Concept (Investment Triangle)

In the past, the InvA provided for a separation of investment firms and custodians, both contrasting with the investor, in whose interest they must always act. In the past, this so-called 'investment triangle' did not apply to unregulated fund structures. The draft of the GIC provides for replacement of the term 'custodian' (*Depotbank*) with that of 'depositary' (*Verwahrstelle*). Under the new framework of the draft of the GIC, a depositary must be designated for any investment fund in the future.

Fund Vehicles According to the GIC

Additional changes are planned in the area of fund types. Although the current distinction set out in the InvA between contractual Special Investor Funds of investment firms and statute-defined sub-funds of investment stock corporations (*Investmentaktiengesellschaft* – InvestmentAG) shall be retained, an additional investment fund in the statute defined form, the investment limited partnership (*Investmentkommanditgesellschaft* – InvestmentKG), is being introduced into law. This creates a new closed-ended investment vehicle in Germany for tax-transparent pooling of a company's pension funds as well as for real asset investment funds. The draft of the GIC also provides a distinction between open-ended and closed-ended funds for investment funds. Closed-ended funds must choose between an InvestmentAG (with fixed capital) or a closed-ended limited partnerships, so called InvestmentKG. This system of categorisation also applies, in principle, to Special Investor Funds (*Spezialfonds*), which may be set up as open-ended and closed-ended Special Investor Funds in the future. Going forward, it will be possible to set up the so called "light regulated Special Investor Funds" previously frequently used by insurance companies as an open-ended Special Investor Fund AIF with 'fixed investment conditions'.

Depositary

For the custodian, the draft of the GIC uses the term 'depositary' originating from the UCITSD and the AIFMD and, due to the deviating prescriptions in the two Directives, provides for separate regulations for UCITS depositaries and AIF depositaries. Here, from the perspective of investor protection, some mandatory, stricter rules for AIF depositaries were carried over to UCITS depositaries and in anticipation of Directive UCITS V (cf. with regard to our May 2012 *DechertOnPoint* on the stricter requirements on depositaries in the draft of Directive UCITS V).

In transposition of the provisions of the AIFMD, depositaries shall be mandatory for all AIFs under the new system in the draft of the GIC. This also applies to closed-ended AIFs investing exclusively or significantly in non-depositable assets. For Mutual Fund AIFs, selection and changing of depositaries is subject to the approval of the German Federal Financial Supervisory Agency (*Bundesanstalt für Finanzdienstleistungsaufsicht* – BaFin).

The legislature has not made any use of the option permitted under the AIFMD to provide for certain professionally supervised providers as depositaries for closed-ended funds which, in principle, invest in non-depositable assets. According to the draft of the GIC, only credit institutions, securities firms and certain other comparably supervised institutions can be designated as depositaries. It can be assumed that this will put German AIFs at a disadvantage in terms of costs with respect to foreign AIFs.

The depositaries bear primary responsibility for the safekeeping of an AIF's investments, in particular financial instruments that can be entered into an account for financial instruments on the depositaries' books and all financial instruments that can be physically transferred to the depositary. For all other non-depositable assets, the obligation to verify the legal ownership relationship shall apply in place of the deposit requirement.

Another primary duty of the depositary is to provide proper monitoring of the AIF's cash flows. In particular, it shall verify that the funds of the investors and the cash resources of the AIF or, where applicable, the AIFM working for the AIF, are being transferred properly to the relevant accounts opened in the name of the AIF, the AIFM working for the AIF or the depositary working for the AIF.

In addition to this, depositaries must also perform certain oversight and approval duties with regard to certain transactions for an AIF, largely corresponding to the existing requirements already given in the InvA (e.g., verification of the legality of the AIF management company's instructions).

Impact on Taxation

According to the reasoning of the draft of the GIC, the revision of the German investment law is being separated from the tax regime for investment funds (the "German Investment Tax Act", GITA). It looks like the change of the regulatory regime for investment funds in Germany is not coordinated with a subsequent change of the investment tax regime. Hence, it is not yet clear as to whether (i) all fund structures falling under the draft of the GIC will fall under the GITA in the future or whether this will be the case only for (ii) open-ended investment funds or (iii) all non-AIFs. However, a full expansion of the GITA to the future area of application of the draft of the GIC appears unlikely because (for InvestmentKGs) this would interfere with the general income tax principles for taxation of partnerships. On the other hand, application of the GITA to closed-ended funds with the legal form of an InvestmentAG would be necessary in order to make these vehicles usable in practice. Otherwise German corporation or trade tax would be due, which would not be due under the GITA that provides for an exemption of German fund vehicles.

For any existing fund structures that may need to be restructured in the future — observing any transition deadlines — due to mandatory provisions of the draft of the GIC, resulting in possible tax consequences (e.g., realisation of hidden reserves, for instance when switching to a tax regime outside of the GITA), it is hoped that the tax legislature will address these issues with appropriate exemptions or transitional provisions.

Outlook

The draft of the GIC is a step forward for harmonisation in the area of investment law, which will now extend beyond just UCITS funds. However, it can be assumed that the AIFMD will not be the end of the harmonisation attempts at the European level. On the contrary, there are already further drafts of directives and regulations in the area of investment and capital market law at the European level. Some specific examples would be the UCITS V and UCITS VI Directives, the MiFID II Directive and the Regulations on European venture capital funds and European social entrepreneurship funds.

Following this introduction, this *DechertOnPoint* will cover some topics of particular relevance.

Hedge Funds

Single Hedge Funds

'Funds with additional risks' (*Sondervermögen mit zusätzlichen Risiken*) in the sense of the InvG are now designated in the draft of the GIC as 'hedge funds'.

Whereas units in hedge funds currently can only be distributed by way of private placement and public distribution is prohibited under the current regime even the private placement will be prohibited in the future. Under the draft of the GIC, it will only be possible to set up hedge funds in the future as open-ended Special Investor Fund AIFs the units of which may be held by professional investors only.

Significant changes are being applied to the range of assets eligible for investment by hedge funds: the currently conclusive catalogue of eligible assets under the InvA, which for Special Investor Funds hedge funds excludes certain investments such as in non-securitised loan receivables and commodities other than precious metals, has no counterpart in

the draft of the GIC, i.e., it is permitted, in principle, for a hedge fund to purchase all investments eligible for any AIF.

In the future, a limit will only be set by the general requirement in Section 249(1) of the draft of the GIC on *general open-ended domestic Special Investor Fund AIFs*, which is to expressly apply also to hedge funds. According to this, hedge funds must invest at least 'predominantly' in *financial instruments*, referring to the definition of this term in the MiFID Directive. In the absence of a definition of the term 'predominantly', it can be assumed that in the future up to 49% of a hedge fund's portfolio could be invested in, for instance, non-securitised loan receivables (which could prove to be an advantage for certain distressed-debt strategies).

The draft of the GIC also does not provide for a counterpart to the former 30% limit on holdings in undertakings that are not admitted to a stock exchange or included in an organised market. With regard to the overall portfolio, it is only necessary to ensure that the fund is investing 'predominantly' in financial instruments. Thus, an investment of up to 49% in non-listed holdings in undertakings should be permitted. In contrast to this liberalisation at the level of the overall portfolio, there is the new restriction at the target investment level that AIF KVGs must now ensure that the hedge fund does not gain control over the target firm, i.e., it cannot hold more than 50% of the voting rights in a company.

Under current law, an "in principle unlimited" level of leverage (whereas it is generally accepted that an investment firm must be free to restrict this in the applicable contractual conditions) and short selling are the two alternative characteristics of a single hedge fund. The draft of the KABG requires short selling or (any) leverage. The motivation for this change is unclear as it results in any Special Investor Fund AIF with a limited range of investment products and minimum leverage qualifying as a hedge fund. The fact that this is obviously an editorial oversight is immediately made clear by the disclaimer given for funds of funds which, to the contrary, warns that a fund of funds invests in (single) hedge funds that "are not subject to any legal restrictions on leveraging [...]".

Funds of Funds

According to the new terminology for hedge funds, the term 'fund of funds' is used in the draft of the GIC instead of 'fund of funds with additional risk'.

The regulations in the draft of the GIC largely retain the regulations from the InvG.

However, it is not clear why the draft of the GIC permits, at the target fund level, on the one hand, a prime broker as an alternative to depositing with a depositary and, on the other hand, requires mandatory submission of confirmation of the value of the target fund by the — optional — depositary. In this regard, we believe this is a case of an editorial oversight.

Changes are being applied with regard to the obligatory disclaimers on prospectuses, which in the future will forgo indication of the total loss risk.

In the future, it may no longer be permitted to offer a promise of a minimum payment on redemption. According to the draft of the GIC, this will only be possible in the future for UCITS KVGs.

Private Equity Funds

Closed-ended Investment Funds

Investment in private equity is an investment in illiquid assets. Private equity funds typically provide their investors either no redemption right or only a very limited redemption right. In the sense of the draft of the GIC (redemption not required at least once a year), private equity funds should therefore normally be regarded as closed-ended.

In Germany, according to the draft of the GIC, closed-ended investment funds may only be set up as investment stock corporations (InvestmentAGs) with fixed capital or as closed-ended InvestmentKGs.

Even if the liquidity necessary to qualify as an open-ended investment fund (with at least annual redemption rights) could be generated from an operational point of view, it must be taken into account that open-ended Special Investor Fund AIFs must invest predominantly in financial instruments and cannot have control over unlisted companies.

The draft of the GIC therefore only permits significant investments in private equity investments in the form of closed-ended Special Investor Fund AIFs. However, open-ended Special Investor Fund AIFs ("with fixed investment conditions") may invest up to 20% in minority holdings alongside the otherwise eligible investments. Technically, the draft GIC defines as Special Investor Fund AIFs in the form of a "Private Equity Fund" only such funds that acquire controlling private equity investments (i.e., at least 50% of a portfolio company).

Acquisition of Holdings in Unlisted Companies

KVGs that manage AIFs that acquire control in unlisted companies alone or collectively with other AIFs, which are not small or medium-sized enterprises nor companies that would also be purchasable by closed-ended Mutual Fund AIFs, must adhere to detailed reporting and disclosure requirements. After acquisition of control, they must also adhere to special regulations intended to prevent exploitation of these companies.

Reporting requirements apply on reaching, exceeding or falling below the holdings thresholds of 10%, 20%, 30%, 50% and 75% in all unlisted companies.

Institutional Funds

Area of Application

In Germany, according to the draft of the GIC, the only fund category available to institutional private equity funds is the closed-ended Special Investor Fund AIF. Here, investors can only be professional investors within the meaning of the draft of the GIC.

In contrast, in the scope of application of the Regulation on European venture capital funds (still in the draft phase), what are known as 'semi-professional' investors are also permitted to invest in qualified small to medium-sized enterprises in the sense of the Regulation. This also applies to the scope of application of the Regulation on European social entrepreneurship funds (also still in the draft phase) for investments in qualified small to medium-sized enterprises operating in the social sector.

Eligible Assets

All assets the commercial value of which can be determined are eligible. Closed-ended Special Investor Fund AIFs must invest predominantly in assets that are not financial instruments. The concept of financial instruments also includes unlisted securities, which is obviously not appropriate in the context at hand. It would be a welcomed development if this does not have to wait for a bulletin from the BaFin (as was the case with the definition of the elements of asset management not subject to licence requirements) to clarify that equity financing and other customary forms of participation in private equity funds are not investments in financial instruments, even though they are formally accompanied by the purchase of financial instruments.

Use of Leverage

The draft of the GIC explicitly addresses only short-term loans. The fact that the use of long-term loans, typical for investments, must also be possible is evident in references in the draft of the GIC to the general regulations restricting use of leverage by the BaFin. At any rate, it is questionable whether short-term loans can be regarded as leverage at all, especially since it is to be expected that the EU Regulation implementing the AIFMD (AIFMR) will establish that short-term loans covered by capital commitments should not be regarded as leverage (cf. Art. 8(4) of the draft AIFMR).

Because external capital is not customarily used for private equity funds at the fund level, but rather at the level of the acquisition companies, the future details of the AIFMR will determine when the use of external capital at companies controlled by the AIF will even have to be taken into account (cf. Art. 8(3) of the AIFMR).

Private Equity Mutual Funds

Mutual Funds in the form of limited partnerships are a German speciality, which went completely unregulated for a long period of time and only came under regulation with the German Prospectus Act. Since 1 June 2012, the German Investment Products Act (*Vermögensanlagengesetz*) has applied to the sale of shares in mutual limited partnerships.

The German Investment Products Act will be completely replaced by the draft of the GIC on expiry of the transitional provisions.

From among the categories in the draft of the GIC, only the closed-ended Mutual Fund AIF is available to private equity Mutual Funds. Unfortunately, holdings in companies are not a permitted asset unless they are holdings in Public Private Partnership project companies or companies possessing or operating properties, ships, aircraft or power generation plants with renewable energies.

Thus, an investment in private equity for Mutual Fund AIFs is basically only indirectly possible as a fund of funds. However, a fund of funds of this kind may only invest in domestic closed-ended Special Investor Fund AIFs according to the draft of the GIC as well as in European and other foreign Special Investor Fund AIFs whose investment policies are subject to comparable requirements.

Holding Companies

Holding companies will continue to exist according to the German Holding Company Act (*Gesetz über Unternehmensbeteiligungsgesellschaften*) that enjoy certain advantages in terms of insolvency law, income tax law and banking oversight law. However, they will also be subject to the requirements of the draft of the GIC.

(Open-ended) Real Estate Funds

Restrictions on Closed-ended Funds

According to the draft of the GIC, it will no longer be permitted in the future to set up open-ended real estate funds. This applies both to Mutual Funds and to Special Investor Funds.

This restriction is a surprise to the industry since just in the recent amendment of the InvA new restrictions for open-ended real estate funds were introduced. Among other things, restrictions on redemption (retention terms and notice periods for cancellation) were introduced that must be applied to existing funds by 1 January 2013. Also, for various interpretation issues in the new statutory regulations, have just been clarified between the German Federal Association of Investment Companies (*Bundesverband Investment und Asset Management e.V.* – BVI) and the German Banking Association in the form of an (FAQ) members' circular harmonised with the BaFin (20 June 2012).

According to press releases, it was however a general interest of the federal government to exclude the establishment of new open-ended real estate funds within the framework of the revision of the InvA. It is particularly surprising that open-ended Special Investor Fund real estate funds will not be permitted in the future because no liquidity issues had been observed in these, nor were any expected, in principle, in light of the typical provisions used in corresponding contractual agreements with institutional investors.

The establishment of new real estate funds will therefore only be possible in the future in the form of closed-ended funds, either as Mutual Fund AIFs or Special Investor Fund AIFs.

On the other hand, it should be possible to limit the practical consequences of the restriction of real estate funds to closed-ended investment funds with corresponding contractual arrangement of the investment fund. This is because the 'closed-ended investment fund' includes all investment funds for which the investor is not permitted to demand redemption of its fund shares at least once per year. A comparable redemption restriction will also exist, in principle, under the regulations that will apply to existing open-ended real estate funds starting from 1 January 2013. This is because if the investment limit of EUR 30,000 is exceeded, a redemption deadline of 12 months shall apply along with a minimum retention period of 24 months. Therefore, according to the wording of the draft GIC, it should be possible, depending on the arrangement of the legal form, to provide for comparable redemption rights after a period of one year (e.g., once every two years) in future closed-ended real estate funds as well. However, it will be necessary to take into account restriction of external financing to 30% of the fund capital.

Grandfather Clause for Existing Open-ended Real Estate Funds

For real estate investment funds established before the time of the cabinet decision on the draft GIC, the provision of a full grandfather clause is intended. This also includes issuing new investment shares. Existing open-ended real estate funds therefore will not be faced with form restrictions even after the draft GIC is passed into law. Nevertheless, in the future, open-ended real estate funds will, in principle, qualify as AIFs. The transitional provisions therefore provide for partial application of certain fund-related provisions from the draft GIC to open-ended real estate funds as well.

Legal Form Restrictions on Closed-ended Real Estate Funds

Due to the legal form restrictions for closed-ended investment funds, in the future it will only be possible to establish closed-ended real estate funds as InvestmentAGs with fixed capital or as closed-ended InvestmentKGs.

If applicable, it may be possible for open-ended investment funds to acquire indirect investments in real estate within the framework of the eligible assets valid at that time. This applies, for instance, to all open-ended funds for holdings in closed-ended real estate funds as long as these qualify as securities in the sense of the draft of the GIC or to open-ended Special Investor Fund AIFs if shares are purchased in domestic or foreign real estate AIFs.

Consequently, the newly proposed regulation might increase the attractiveness of foreign fund locations for open-ended real estate funds (Luxembourg, Ireland). Foreign open-ended real estate funds of this kind should, in principle, remain eligible

investments in the future as well for, e.g., insurance companies as per the provisions of the Investment Ordinance (*Anlageverordnung* – AnlV) (and the associated investment circular and commentary). Particularly in the light of the restriction of permissibly leverage of 30%, structuring real estate fund vehicles as a (G-) REIT may be an alternative option.

Closed-ended Real Asset Funds (Closed-ended Mutual Fund AIFs, Special Investor Fund AIFs)

Overview

Closed-ended funds, up to now unregulated in terms of their investment policy and management, will now be assigned in their entirety to the regulated segment under the draft of the GIC. The approach to new regulation of the legislator indicates the following major regulation principles for closed-ended funds:

- **Mandatory legal form:** Closed-ended domestic investment funds may be set up solely as an InvestmentAG with fixed capital or closed-ended InvestmentKG. This is based on the supposition that these legal forms, in particular the GmbH & Co KG (limited partnership with a limited liability company as general partner), correspond to the legal forms primarily selected by closed-ended funds up to now and, furthermore, they eliminate liability risks for investors. Moreover, the legislator advises that these fund vehicles correspond to the fund vehicles common in the EU, so that there would be nothing to fear regarding any competitive disadvantages entailed for German funds.

- **Investors as shareholders:** The ultimate consequence of this mandatory legal form is that investors may participate in closed-ended funds (both Mutual Fund AIFs and Special Investor Fund AIFs) only as shareholders. As a supplementary measure, the breakdown of the shares into voting shares and non-voting shares has been nullified with regard to (closed-ended) InvestmentAG with fixed capital. This is based on the consideration that investors should have a shareholder's position and shareholders' rights as compensation for the lack of redemption rights.

- **Restriction of assets to illiquid assets:** Both closed-ended Mutual Fund AIFs and closed-ended Special Investor Fund AIFs must invest their funds primarily in assets that are not financial instruments within the meaning of the AIFMD. This requirement is meant to differentiate (liquid) open-ended and (always illiquid) closed-end funds. With regard to closed-ended Mutual Funds, it is supplemented by a restricted list of eligible assets for reasons of investor protection.

- **Differentiation between closed-ended Mutual Fund AIFs and Special Investor Fund AIFs:** While stronger product-based constraints are intended for Mutual Fund AIFs, they only apply to Special Investor Fund AIFs on a limited basis.

- **Restriction of debt financing:** Leverage (on the fund level) is to be limited to 30%.

Product Regulation of Mutual Fund AIFs

A product regulation based on investment law will be introduced for the first time for Mutual Funds investing in real assets. The legislator has recognised in this context the necessity of specifying a conclusive catalogue of acceptable assets for Mutual Funds. Alongside real estate, ships and airplanes, closed-ended AIFs may acquire plants for the generation of electricity from renewable energies, holdings in Public Private Partnership project companies as well as holdings in special purpose companies, which hold the aforementioned asset. In addition, they may acquire shares and stock in other (regulated) closed-ended AIFs. Direct investments in (other) holdings (among other things, private equity holdings), on the other hand, are not permitted. Closed-ended Mutual Fund AIFs, however, may invest in other private equity funds (i.e., closed-ended Special Investor Fund AIFs). Furthermore, up to 49% may be invested in financial instruments (which, incidentally, constitute the investment focus of open-ended funds).

Investments in other assets, e.g., timber funds, mezzanine funds, other energy and infrastructure funds do not constitute eligible assets. The legislator claims that otherwise there would be no feasible means to implement an effective investor protection with respect to certain specifically risky assets. Obviously, this results in a significant limitation of activities of investment companies, which manage retail money, in the area of real asset investments as far as the investment is structured via an investment fund. However, different

restrictions under regulatory law apply with regard to other investment structures such as via structured debt instruments.

Single Asset Funds

Shares of closed-ended Mutual Fund AIFs, which invest in only a single asset, so-called single asset funds, may be acquired only by so-called semi-professional investors. Alongside a minimum investment amount of EUR 50,000, these semi-professional investors have to comply with further rules and regulations. All other closed-ended Mutual Fund AIFs must invest according to the principle of risk diversification; in the area of real asset investments, however, this principle requires further specification by the legislator or the administration. For example, does a commercial property with a multitude of different tenants already constitute risk diversification?

Introduction of Depositary and Valuation Entity

In the future, the integration of real asset funds into the scope of the investment law will subject these funds to the structural requirements already in place for other investment funds; in particular, they will be subject to the requirement of having to involve an external depositary. Special rules are in place with respect to the valuation entailed in the acquisition as well as the recurrent valuation of assets.

Special Regime for Investment Limited Partnerships

The investment legislator intends to provide certain special rules under company law that deviate from known limited partnership model regarding the structure of partnership agreements of InvestmentKGs. An example in this context is the obligation that the InvestmentKG is to be exclusively managed through its general partners. Under the draft GIC it would not be feasible to avoid being "deemed trading" for income and trade tax purposes by introducing a so-called managing limited partner in the partnership agreement.

Furthermore, mandatory rules for book depreciation of assets held by the closed-ended Mutual Fund AIF (depreciation period of a maximum of ten years) need to be mentioned. A reduction of the partnership assets below the contractual partnership assets of the InvestmentKG and/or distributions to investors in such case leads to follow-up obligations under regulatory law. Since, in case of real asset funds, the ongoing distributions frequently exceed the amount of the balance sheet profits, especially with a view to the new provisions on the depreciation of assets. As a result, under the current draft of the GIC, InvestmentKGs would regularly violate these planned statutory rules. Again there is room for improvement in this respect in the further legislative procedure.

Investment Limited Partnership (Pension Pooling)

In addition to the InvestmentAG, the draft of the GIC introduces a new type of investment fund, the InvestmentKG, which can be structured either as open-ended or closed-ended investment funds. This is to provide professional investors with a fiscally transparent vehicle for the so-called pension asset pooling in Germany. The goal is to keep the pension money of major German corporations in Germany. In addition, the limited partnership is a legal form long established in the area of unregulated closed-ended funds, focusing on illiquid investments.

Open-ended InvestmentKG

The open-ended InvestmentKG is a limited partnership within the meaning of the German Commercial Code (*Handelsgesetzbuch* – HGB). Thus, in principle, the civil law standards of the HGB are to be applied to open-ended InvestmentKGs, provided the draft of the GIC does not stipulate special rules. The partnership agreement of the open-ended InvestmentKG, which is subject to the written form requirement, must state as business purpose the investment and management of the open-ended InvestmentKGs assets according to a set investment strategy and the principle of risk diversification for joint capital investment for the benefit of the investors.

The shares in the open-ended InvestmentKG may be held exclusively by professional investors within the meaning of the draft of the GIC. A direct investment is only possible as general or limited partner. Additional funding obligations of the investors of the open-ended InvestmentKG are excluded in the draft GIC. In order to prevent an unlimited liability of a limited partner, possible according to the HGB for liabilities arising in the time period between joining the limited partnership (*Kommanditgesellschaft* – KG) and the registration of the limited partner in the commercial register, the joining of the limited partner of an open-ended InvestmentKG becomes effective only with the limited partner's registration in the commercial register.

Only one or several general partners are permitted to manage the open-ended InvestmentKG. The management board has to comprise at least two reliable and professionally qualified persons.

In the case of the open-ended InvestmentKG, the management board may name an external KVG, which will be responsible in particular for the portfolio management and the administration of the InvestmentKG's investment assets. Should the InvestmentKG assume the management itself, through its general partner, it becomes a so-called internally-managed InvestmentKG and will be considered an internal AIF-KVG. An internally-managed InvestmentKG can establish its own business operating assets, which — separated from the investment capital — encompass the capital required for the management of operations.

The partnership agreement of an open-ended InvestmentKG may permit the creation of sub-funds. Investment conditions must be drawn up for each sub-fund, and a depositary has to be designated for each sub-fund. The liability of the limited partners is limited to liabilities of that sub-fund in which they have a share. In contrast, general partners are liable for the liabilities of all sub-funds of the open-ended InvestmentKG.

At least once a year, an open-ended InvestmentKG has to grant its limited partners the opportunity to terminate their investment either in full or in part. The continuing liability of a departing partner according to the HGB will be excluded under the draft of the GIC. The right of termination exists only if the payout of the share does not result in an amount lower than the initial capital and the requisite minimum capital.

Distributions resulting in a reduction of the value of the partnership share below the capital contribution require the consent of the investors concerned. It is not clear under the draft of the GIC whether this refers to the liability contributions or the entire contributions.

The Closed-ended InvestmentKG

The closed-ended InvestmentKG is also a limited partnership within the meaning of the HGB, which in principle is subject to the standards of the HGB, provided the draft of the CIC does not stipulate any deviations. The business purpose of the closed-ended InvestmentKG is limited to the portfolio management and the administration of its assets on the basis of a defined investment strategy. The strategy has to be geared towards a predominant investment in assets other than financial instruments for the joint capital investment and the benefit of the investors.

An investor can invest in a closed-ended InvestmentKG as limited partner or via a trustee acting as limited partner. If the closed-ended InvestmentKG is designed as a closed-ended special InvestmentKG, it is available to professional investors only.

In contrast to the open-ended InvestmentKG, the establishment of sub-funds is not permitted for the closed-ended InvestmentKG — this also applies to InvestmentAG with fixed capital. Contributions in kind are not permitted. The formation of various "classes of units" shall apparently be acceptable.

For the protection of investors' rights, a supervisory board is to be established in the case of an internally-managed closed-ended InvestmentKG.

The aforementioned special regulations existing for open-ended InvestmentKG to avoid liability in the event of the departure of a general partner or a limited partner do not apply to closed-ended InvestmentKGs.

Investment Stock Corporations

The main innovation with respect to the InvestmentAG — the German SICAV/F — is the reintroduction of an alternative with fixed capital as a vehicle for closed-ended funds. Along the closed-ended InvestmentKG, the InvestmentAG with fixed capital will be the only other vehicle for the establishment of closed-ended funds in the future. The changes in the area of the InvestmentAG as a vehicle for open-ended fund structures are predominantly of an editorial nature.

Changes in the Area of the InvestmentAG With Variable Capital

According to the changed terminology, a differentiation will be made not only between Mutual and Special Investor Fund InvestmentAGs but also between AIF- and UCITS-InvestmentAGs in the future. The possibility of implementing third party-managed and self-managed InvestmentAGs will continue to exist (the third-party management company is designated as external asset management company, the self-managed InvestmentAG as internal asset management company).

The licensing conditions for an externally-managed UCITS-InvestmentAG with variable capital are the

only matter regulated directly in the context of the provisions for the InvestmentAG with variable capital. With regard to the InvestmentAG with variable capital, the draft GIC refers to the general licensing conditions for UCITS and AIF KVGs. Thus, it will be possible to establish a so-called Super-InvestmentAG in the future.

(Re-)Introduction of the InvestmentAG With Fixed Capital

The legal structure of the InvestmentAG with fixed capital is to a large extent identical to that of the InvestmentAG with variable capital: At its core it also refers to a joint-stock corporation to which the regulations of the Stock Corporation Act (*Aktiengesetz* – AktG) are generally applied, provided no special provisions of the draft of the GIC exist. Compared to the InvestmentAG with variable capital, there are three essential differences.

No Non-voting Shares

The draft does not provide the option of issuing non-voting shares. Thus, according to the present status, all investors have the right to attend the annual shareholders' meeting and are entitled to vote at the meeting. According to the legislator, this restriction is justified with the protection of the investors: Since it is impossible for the investors to redeem their shares in case of dissatisfaction with decisions made by the company, every shareholder needs a voting right.

Applicability of the AktG With Respect to Capital Procurement and Capital Reduction

In contrast to the InvestmentAG with variable capital, the provisions of the AktG with respect to capital procurement and capital reduction apply (Sections 182 *et seq*. of the AktG) to the InvestmentAG with fixed capital. This renders the InvestmentAG with fixed capital considerably more inflexible than its sister, which is why it was not accepted in the past and abolished by the German Investment Modernisation Act in 2007. In combination with the impossibility to issue non-voting shares, the existing shareholders are thus in the position to prevent capital increases and the admittance of new shareholders. In practice, this might turn out to be a substantial obstacle for the InvestmentAG with fixed capital.

No Sub-funds

Similar to the InvestmentKG, the draft GIC provides the option of launching sub-funds only for the InvestmentAG with variable capital at the moment. As a consequence, a separate vehicle has to be launched for every closed-ended investment fund. In our opinion, this also represents a disadvantage, especially in view of the competition with the jurisdictions Luxembourg and Ireland.

Marketing of Funds

Expanded Marketing Concept: Abolishment of Private Placement

The present rules for the marketing of investment funds are subject to substantial changes under the draft GIC. A key change is the expansion of the concept of "marketing", which will replace the concept of "private placement". While under the InvA (with the exception of provisions for single hedge funds), only "public marketing" is relevant in terms of regulatory law, in the future, the concept of "marketing" will encompass the direct or indirect offering or placement of shares or stocks of an investment fund as well as advertising for an investment fund or a management company. As a consequence of this revised concept, the previous regulation contained in Section 2(11) of the InvA, according to which the marketing to certain institutional investors is not considered as public marketing, will be discarded. In content, a large number of the previously existing exemptions provided in Section 2(11) of the InvA, however, will continue to apply. Such activities (e.g., the designation by name of an investment fund, the publication of issue and redemption prices, the disclosure of taxation bases pursuant to Section 5 of the GITA are also not considered "marketing" under the draft GIC. In this respect, the concept of "public" marketing no longer plays a role.

This also means that all investment funds currently placed under the "private placement regime" in Germany have to retroactively submit registration notifications. The draft GIC provides a period of one year for obtaining such registration after the draft of the GIC comes into effect, i.e., until July 2014.

Definition of Investor

The adoption of the investor classification of the Securities Trading Act (*Wertpapierhandelsgesetz*) introduced by the MiFID Directive in order to set up different marketing requirements based on this classification constitutes another pillar of the marketing regulations of the draft GIC. Investors are classified either as "professional investors" or as "retail investors". With regard to professional investors, it is assumed that they possess sufficient experience, knowledge and expertise to be able to

make their own investment decisions and to appropriately judge the risks entailed therein. The classification in one of the two groups is initially performed according to objective characteristics and is binding. Only legal entities such as banks, funds, insurance companies and other institutional investors are automatically considered professional investors. An option exists, however, for the investors to be classified in the other group based on the initial legal classification. Thus, retail persons, for example, can become professional investors. On principle, the duties to provide information stipulated in the AIFMD initially apply to both groups. When regulating the marketing directed at retail investors, however, the German legislator went beyond these provisions and made use of the option to stipulate stricter rules as provided by the AIFMD. This applies first and foremost to comprehensive duties to provide information and to certain disclosure obligations.

Notification Obligation for All Funds Before Starting Marketing

Also new is that a notification to the BaFin must take place prior to the start of the marketing of all AIFs — including domestic ones(!). For UCITS funds, on the other hand, the known disclosure procedure (EU passporting) remains in place.

The rules for the notification procedure for AIFs differentiate between the marketing of domestic AIFs, EU AIFs or AIFs from third countries, whether the marketing is directed at professional investors or retail investors, and, finally, whether master-feeder funds are marketed or referred to. This results in a regulation of the AIF notification provisions of the draft of the GIC on an almost individual case-like basis. With respect to the marketing to retail investors, foreign AIF management companies must designate a reliable, suitable representative with a registered office in Germany, among other things. In contrast to the current legal situation, however, this representative must be able to exercise the compliance function for the management and marketing activities.

EU Passport for Certain Funds

Another essential element with regard to the marketing of AIFs to professional investors is the EU passport provided for in the AIFMD, which entitles a fund management firm authorised in a member state to conduct marketing of AIFs on an EU-wide basis. The management company from a non-EU country, however, first has to register in a reference member state of the European Economic Area (EEA).

Licensing Issues (Especially Outsourcing)

Separate Permit Procedures for the Management of UCITS and AIFs

The new KVG as such can — provided it is appropriately licensed — act as a management company of UCITS as well as of AIFs (and thus as AIFM). Since the conditions for granting a licence are regulated differently in the UCITSD and the AIFMD, the draft of the GIC contains different provisions for the licensing procedures for UCITS KVGs and AIF KVGs.

The licensing requirement for AIFM is new only for those providers who have, without a licence, previously launched and managed closed-ended funds that were not covered by the InvA and were thus unregulated. The companies already regulated by the InvA, on the other hand, have to apply for an additional licence for the management of AIF, alongside the existing UCITS licence, to be able to continue to operate all areas of their previous business model (launch and management of non-UCITS).

Outsourcing the Portfolio Management or Providing Investment Advice

Management firms that do not wish to be regulated as KVG or AIFMs themselves may provide the portfolio management for AIFs via an outsourcing agreement provided the prerequisites for an outsourcing are met. The draft of the GIC regulates the outsourcing by implementing the AIFMD for AIF management companies and UCITS management companies in a largely uniform manner, in some cases going beyond the previous outsourcing provisions of the InvA.

It must be noted that the further implementation of the provisions regarding outsourcing as per an EU Regulation is uniformly regulated for the entire EU. Thus, there is no longer any leeway for implementation on a national basis. The adoption of the AIFMR is to be expected soon.

The outsourcing entity, as for UCITS management companies, needs to have sufficient resources for carrying out the tasks assigned to it; and — this is new — the persons who actually manage the business of the outsourcing entity have to be reliable and must be sufficiently experienced.

If the outsourcing concerns portfolio management *or* risk management, it is only permitted to commission outsourcing entities that are authorised or registered to provide asset management or

financial portfolio management and are subject to supervision (as is already currently the case where portfolio management is outsourced). An exception is made for AIF KVGs, who, subsequent to prior authorisation by the BaFin, are permitted to outsource the portfolio management or risk management of Special Investor Fund AIFs under their management to companies that have not been authorised for asset management purposes. The requirements for a sufficient licence will be substantiated in greater detail in the AIFMR. Management companies in Germany that want to manage AIFs as part of an outsourcing agreement will thus require a portfolio management licence according to the German Banking Act (*Kreditwesengesetz* – KWG).

The KVG (i.e., with self-managed closed-ended AIFs, InvestmentAG or InvestmentKG) is not permitted to transfer tasks to such an extent that it can no longer be considered a management company and turns into a "letterbox entity". The requirement that either only the portfolio management or only the risk management may be outsourced — but not both functions — must also be seen in this context.

Via the "detour" of the AIFMD, the requirement that any outsourcing has to be notified to the BaFin before the outsourcing agreement comes into effect has been reintroduced. In 2008, the Act Amending the InvA created the possibility to notify such outsourcings only collectively and at the end of the financial year.

If a "portfolio manager" cannot or does not wish to apply for an AIFM licence or a MiFID portfolio management licence, the only option is to be instructed as an investment advisor. This requires, however, a corresponding investment advisor registration according to Section 32 of the KWG if the advisory function refers to financial instruments within the meaning of the KWG and no exemption applies. In this case again, however, the aforementioned substance requirements have to be complied with.

Exemptions From the License Requirement

The *de-minimis* rule contained in the AIFMD does not apply to management firms of Mutual Funds. This means that only AIF KVGs, which exclusively manage Special Investor Fund AIFs, are exempt from an authorisation requirement and are subject merely to a registration obligation and certain reporting obligations to the BaFin if one of the thresholds contained in the AIFMD is met. For reasons of investor protection, the rules of the draft of the GIC are to be fully applied to management firms of Mutual Fund AIFs independent of the size of the fund. The legislator justifies this first and foremost with the assumption that it is immaterial with respect to the protection needs of retail investors whether the investor invests in a small or a large fund.

Transition Periods for the Granting of Licenses

The draft of the GIC provides general transition rules for AIF management companies and AIFs in Section 311. The rule implements Art. 61(1) of the AIFMD. AIF KVGs accordingly have to apply for a licence or registration within a period of one year pursuant to the draft GIC. In parallel it is intended, however, that, after the law comes into effect, AIF KVGs will only be permitted to establish new AIFs if they have obtained a licence or registration according to the draft of the GIC. This considerably constrains the scope of this transition regulation.

■ ■ ■

This update was authored by Robert Eberius, Dr. Carsten Fischer, Dr. Till Friedrich, Martin Hüwel, Angelo Lercara, Achim Pütz, Florian Rinck, Daniel Schäfer, Hans Stamm, Dr. Benedikt Weiser and Dr. Frank Wilbert.

Practice group contacts

For more information, please contact the author, one of the attorneys listed or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financial_services.

Dr. Carsten Fischer
Frankfurt
+49 69 7706194211
carsten.fischer@dechert.com

Martin Hüwel
Frankfurt
+49 69 7706 190
martin.huewel@dechert.com

Angelo Lercara
Munich
+49 89 21 21 63 22
angelo.lercara@dechert.com

Achim Pütz
Frankfurt
+49 69 7706194212
achim.puetz@dechert.com

Hans Stamm
Munich
+49 89 21 21 63 42
hans.stamm@dechert.com

Dr. Benedikt Weiser
Frankfurt
+49 69 7706194220
benedikt.weiser@dechert.com

Sign up to receive our other *DechertOnPoints*.