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German Ministry of Finance Publishes Initial Draft for Implementation of AIFMD

http://beplink.de/5 (pdf; 4.1 MB)

On July 20, 2012, the German Federal Ministry of Finance published the initial draft of an act implementing the AIFM Directive 2011/61/EU into domestic law. The initial draft is for discussion purposes only. An official hearing of the lobby groups will presumably be held in the second half of August 2012.

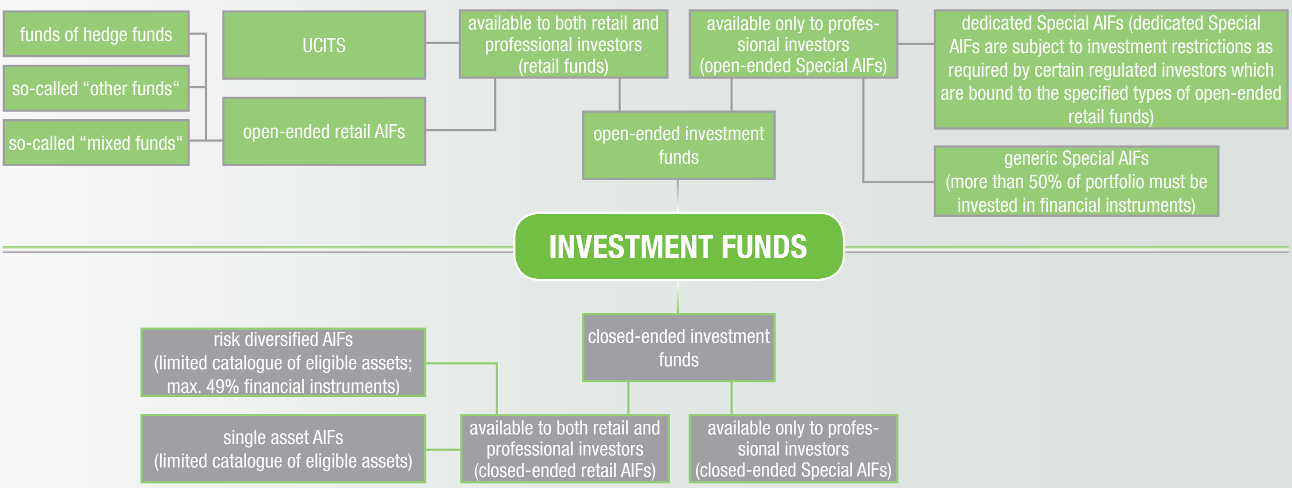
1. New Regulation of German Funds

According to the draft act, the current Investment Act will be replaced by a new statutory regime called *Kapitalanlagegesetzbuch* (Investment Code, or „KAGB“). The KAGB is drafted as a comprehensive regulatory system of rules covering both the managers of UCITS and alternative investment funds (“AIFs”) and any open-ended or closed-ended funds (including UCITS). The draft does not include any tax rules.

With regard to the collective investment schemes, the draft KAGB provides for the umbrella term *Investmentvermögen* (investment funds). Similar to article 4(1)(a)(i) of the AIFMD, said umbrella term is defined as „any collective investment undertaking which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors“.

The umbrella term *Investmentvermögen* includes both UCITS and AIFs, open-ended and closed-ended funds as well as retail and professional investor funds. Based on the umbrella term, the draft KAGB provides additional definitions:

- **UCITS** and **AIFs**: UCITS are any domestic and foreign investment funds which comply with the UCITS Directive 2009/65/EU. Any other investment fund (as defined) is an AIF.
- **Open-ended** and **closed-ended** investment funds: Open-ended investment funds redeem their units/shares upon request by the investors at least once per year. Any other investment funds are closed-ended investment funds.
- **Special AIFs** and **retail investment funds**: Special AIFs are defined as AIFs the units/shares of which may be held exclusively by professional investors. Any other fund is a retail investment fund (UCITS or retail AIF). Professional investor means any investors, which qualifies as a professional investor pursuant to MiFID or who can be treated as a professional investor upon the investor‘s request (the so-called „opt-in professionals“, see Annex II of the MiFID 2004/39/EU).



With regard to German AIFs, we would like to highlight some of the innovations:

- German investment law has provided for regulated open-ended real estate funds for more than 40 years. As a consequence of the so-called „real estate fund crisis", the draft KAGB no longer allows for open-ended real estate funds. Thus, real estate funds (including Special AIFs) may grant the right to redeem units/shares, however, the minimum period between two consecutive redemption dates must be more than one year. The existing open-ended real estate funds will be grandfathered.
- The draft KAGB introduces a new, tax-transparent legal form of funds, the so-called investment limited partnership. Funds can be set up as either open-ended or closed-ended investment limited partnerships. However, the open-ended investment limited partnership will be available only to professional investors (within the meaning of the MiFID).
- Single hedge funds will no longer be available for retail investors. According to the draft KAGB, only professional investors are eligible investors for single hedge funds.
- The draft KAGB provides for closed-ended funds either in the form of investment stock corporations with fixed capital or closed-ended investment limited partnerships. Other legal forms are not allowed for closed-ended funds under the draft KAGB.
- Closed-ended retail funds may invest exclusively in real property, ships, planes, plants producing electricity out of renewable energy, interests in public private partnership SPVs and interests in certain other SPVs. Double-tier structures are allowed, however, a multi-tier structure with several holding and intermediate holding entities is not allowed for closed-ended retail funds according to the draft KAGB. In addition, closed-ended retail funds may acquire and hold interests in other closed-ended funds including closed-ended funds that are reserved to professional investors. Thus, the legislator wants to allow for investments by retail investors in private equity funds indirectly *via* funds of private equity funds.

We agree with the initial comments by some lobby associations stating that the draft KAGB not only transposes the provisions of the AIFM Directive into domestic law, but also provides for the regulation of AIFs which significantly exceeds the requirements of the AIFMD.

2. Distribution/Marketing of Foreign AIFs

Under the current German regulations, private placements of foreign funds (and unregulated domestic funds) do not require the approval of the German regulator (the Federal Financial Supervisory Authority, or „BaFin") nor is a prospectus required under German law. The current regulations (e.g. the Investment Act and the Securities Prospectus Act) apply only if the investment product (fund units, shares, bonds) is distributed to the public. However, regulation under the Banking Act applies to certain financial services providers.

In contrast, the draft KAGB regulates any distribution, i.e., the application of the draft KAGB is not only limited to distribution to the public. Hence, the draft KAGB does not provide for any private placement regime.

2.1 Distribution of EU AIFs and Third Country AIFs to Retail Investors in Germany

According to the draft KAGB, units/shares in EU AIFs and third country AIFs may be distributed to retail investors in Germany if the conditions set forth in sections 283 to 286 of the draft KAGB are fulfilled. In brief, in order to obtain the distribution allowance, the EU AIF and the third country AIF as well as the relevant AIFMs managing such AIFs must be equivalent to the German AIFs and AIFMs for retail investors („equivalency requirement"). Thus, any EU AIF or third country AIF which is intended to be marketed to German retail investors must meet quite rigorous conditions according to the draft KAGB. Please find below a brief summary of the most important requirements that must be fulfilled by a foreign AIF as a result of the equivalency requirement:

- Appointment of a single depositary;
- specific measures for safekeeping immovable fund assets must be taken (e.g. disposal restrictions with regard to real property must be entered into the land register);
- daily redemption of open-ended AIFs, however, less frequent redemptions are allowed for certain specified types of fund;
- detailed provisions relating to eligible assets and investment limits, use of derivatives, securities lending and repos must be observed (i.e. the investment universe is limited);
- max. 49% of a closed-ended AIF may be invested in financial instruments within the meaning of the AIFMD;
- on the other hand, open-ended AIFs must invest more than 50% into such financial instruments;
- debt financing of closed-ended funds may not exceed

30% (open-ended funds are limited to short-term borrowings according to the provisions which apply to UCITS);

- currency risk of closed-ended funds may not exceed 30%;
- closed-ended AIFs may not be set up as umbrella funds or as a master-feeder structure;
- a (open-ended) feeder AIF must be domiciled in the same country as its master fund; in addition, the master fund must fulfill certain requirements, in particular the master AIF must also be licensed for distribution to retail investors in Germany;
- in the case of third country AIFs and AIFMs, the AIF and its AIFM must be domiciled in the same country (i.e. cross-border management is not allowed)

Please note that neither open-ended real estate funds, nor private equity funds, nor single hedge funds can be distributed/marketed to retail investors in Germany as of 2013.

Apart from the requirements in connection with the approval, the foreign AIF and AIFM would have to fulfill extensive information, reporting and publication requirements prior to subscription and continuously during their presence in the German retail market.

All things considered, a foreign AIF, which is intended to be distributed to German retail investors, will be subject to very strict equivalency conditions. Similar to the current distribution regime under the Investment Act, distribution to German retail investors under the draft KAGB will require a very specific fund set-up which aims to obtain the distribution license right from the start of the designing and drafting stage of the fund‘s concept.

2.2 Distribution of EU AIFs and Third Country AIFs to Professional Investors in Germany

With regard to the distribution of EU AIFs managed by EU AIFMs to professional investors, the draft KAGB transposes the AIFM Directive into domestic law. Section 289 of the draft KAGB includes the provisions as set forth in article 32 of the AIFMD. Thus, a EU AIFM managing EU AIFs (including Special AIFs domiciled in Germany) is not required to apply for a manager license in Germany due to the fact that the license was already granted by the EU AIFM‘s state of domicile. The distribution of units/shares in EU AIFs managed by such EU AIFM is subject to the passport regime according to the AIFMD as of the enactment of the draft KAGB (i.e., as of 2013), provided that such EU AIF is not a feeder fund that invests in a third country master AIF that is managed by a third country AIFM.

Furthermore the cross-border management of EU AIFs by EU AIFMs is transposed into the draft KAGB in accordance with article 33 of the AIFM Directive. However, the draft KAGB does not allow for distribution of cross-border managed AIFs, which are outside the scope of the AIFMD passport regime, i.e.

- Third country AIFs which are managed by EU AIFMs or third country AIFMs domiciled in another state, and
- EU AIFs managed by third country AIFMs.

The rules for management and distribution of AIFs connected to non-EU countries are more complex since the AIFMD includes mandatory provisions (which must be transposed by the member states) as well as optional provisions (the member states may decide on the extent of transposition). With regard to distribution of AIFs to professional investors, a connection to a non-EU country exists under the following circumstances:

- A EU AIFM distributes units/shares in **a third country AIF**; or
- a **third country AIFM** distributes units/shares in an AIF (regardless of whether it is a EU or third country AIF).

The AIFM Directive provides for a European passport regime for the distribution of the aforementioned AIFs. However, said passport regime only applies following an evaluation period that ends in 2015. As of 2013 until 2015, the AIFMD allows the member states to have individual distribution regimes for the distribution to professional investors in the relevant member state. Such individual distribution regime must fulfill certain minimum requirements according to article 36 or article 42 of the AIFMD. However, the member states may impose stricter requirements than provided for in the AIFMD. The German legislator has decided to introduce such an individual distribution regime (and to impose stricter requirements) only for

- the distribution of **third country AIFs managed by third country AIFMs**; and
- the distribution of **EU feeder AIFs managed by EU AIFMs** if neither the master AIF nor the master fund‘s AIFM is a EU AIF or EU AIFM, respectively.

2.3 Distribution of Third Country AIFs by Third Country AIFMs: 2013-2015

The distribution of third country AIFs managed by third country AIFMs to professional investors in Germany during the period of 2013-2015 is subject to section 296 of the draft KAGB. Section 296 of the draft KAGB includes the following requirements that exceed the requirements set forth in article 42 of the AIFMD:

- Both the third county AIF and its managing third country AIFM must be domiciled in the same country. Third country AIFs that are cross-border managed may not be distributed to professional investors in Germany until the European Commission decides on the European passport regime for third country AIFs in 2015 (delegated act pursuant to article 67 (6) of the AIFMD). Please note that this rule also applies to third country AIFs that are managed by EU AIFMs as well as to EU AIFs that are managed by third country AIFMs. For example, interests in a AIF organized as an English limited partnership, which is managed by a Delaware general partner, may not be distributed to professional investors in Germany until 2015.
- According to the AIFMD, appropriate cooperation arrangements must be in place between the competent authorities of the relevant member states and the supervisory authorities of the relevant third countries in order to ensure an efficient exchange of information that allows the relevant member states authorities to carry out their duties (see subsection (b) of the first subparagraph of article 42 (1) of the AIFMD). In addition, the supervisory authorities of the country of domicile of the AIF and the AIFM must agree to cooperate with the German regulator (BaFin) in accordance with sections 9 and 10 of the draft KAGB. It is unclear whether or to which extent such cooperation agreement would exceed the cooperation arrangements pursuant to article 42 (1) of the AIFMD since the details for cooperation arrangements will be regulated by a level 2 regulation (see article 42 (3) of the AIFMD).
- The AIF's country of domicile and Germany must conclude an agreement that fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention on Income and on Capital and ensures an effective exchange of information in tax matters. Said agreement is not required by the AIFMD but the EU member states may impose stricter rules on the non-EU AIFM (see article 42 (2) of the AIFMD).
- A depositary according to sections 76-86 of the draft KAGB must be appointed. Sections 76-86 of the draft KAGB correspond to article 21 of the AIFMD. The application of article 21 is not required by the AIFMD. Thus, the German legislator imposes stricter rules regarding the depositary of third country AIFs.
- A German representative must be appointed. Such representative must be able to perform the compliance function relating to the management and marketing activities performed by the AIFM according to article 37 (3) of the AIFMD.
- The fund documents must safeguard that the third country AIF fully complies with the provisions for German Special AIFs as set forth in sections 240-261 of the draft KAGB. Thus, the distribution license requires that any third country AIF is mostly equivalent to the German Special AIFs.
- A German paying agent must be appointed.
- In the event that the third country AIF is intended to be distributed *via* a feeder AIF, then the Master AIF must also be licensed for distribution to professional investors in Germany.

The distribution license is subject to the fulfillment of a notification process (similar to the procedures according to article 31 of the AIFMD). German translations of the documents must be provided.

2.4 Distribution of EU Feeder AIFs with EU AIFMs if neither the Master AIF nor its AIFM is a EU AIF or EU AIFM: 2013-2015

Most of the aforementioned requirements must be fulfilled if units/shares in a EU Feeder AIF managed by a EU AIFM are intended to be distributed to professional investors in Germany and if the Master AIF is domiciled in a third country and managed by a third country AIFM. Please note that units/shares cannot be distributed if the Master AIF is cross-border managed so that EU Master AIFs managed by third country AIFMs, or third country Master AIFs managed by EU AIFMs, are not relevant until 2015.

Thus, the same rules relating to the depositary, the German representative, the equivalency requirement and other requirements apply to the EU Feeder AIF and its EU AIFM. In addition, the Master AIF must be licensed for distribution to professional investors in Germany so that the full set of rules as set forth above (i.e., the minimum standards according to the AIFMD plus the stricter requirements imposed by the draft KAGB) applies to the Master AIF.

2.5 Distribution as of 2015

As of 2015 (delegated act pursuant to article 67 (6) of the AIFMD), the distribution of AIFs will be subject to the passport regime as provided for in the AIFMD. The German legislator does not intend use the option to keep the national distribution regime beyond 2015, although article 42 of the AIFMD allows for such national regime to be retained parallel to the EU passport regime that is to be introduced in 2015.

We will keep you informed of any development.

be in touch: If you have any questions, please do not hesitate to contact us!

Dr. Carsten Bödecker
Partner . Steuerberater . Rechtsanwalt

Tel. +49 (0) 211 946847-51
Fax +49 (0) 211 946847-01

carsten.boedecker@bepartners.pro

Carsten Ernst
Partner . Steuerberater

Tel. +49 (0) 211 946847-52
Fax +49 (0) 211 946847-01

carsten.ernst@bepartners.pro

Harald Kuhn
Partner . Rechtsanwalt

Tel. +49 (0) 211 946847-54
Fax +49 (0) 211 946847-01

harald.kuhn@bepartners.pro

Nathalie Grenewitz
US-Attorney at Law

Tel. +49 (0) 211 946847-57
Fax +49 (0) 211 946847-01

nathalie.grenwitz@bepartners.pro