DechertOnPoint

January 2008 / Issue 3

A legal update from Dechert's Financial Services Group

Significant Amendments to the German Investment Act

Changes For German Investment Management Companies, German Domestic Funds and Foreign Funds, Including Private Placement Rules, UCITS and Hedge Funds

Introduction

Changes to the German investment industry, including a combination of new types of fund offerings and a liberalization and improvement of the previous regulatory scheme, have been implemented by an Act amending the German Investment Act and related provisions of other laws (*Investmentänderungsgesetz*, the "Act").

The general purposes of the changes, detailed below, are to modernize the German investment industry and make it more attractive to potential domestic and foreign investors. In addition, the Act serves to harmonize German statutory law with EU Directive 2007/16/EU (the "Eligible Assets Directive"), which has the practical effect of simplifying or easing many of the previous requirements. At the same time, the changes are intended to improve corporate governance of German funds and to strengthen and improve measures to protect the interests of German investors.

The Act was adopted by the German Legislature (*Bundestag*) on 8 November 2007 and by the German Federal Counsel *(Bundesrat*) on 30 November 2007, and came into force on 28 December 2007.

Changes Applicable to German Investment Management Companies

KAGs No Longer Treated As Credit Institutions

As part of its effort to harmonize German law with the Eligible Assets Directive and to create more attractive investment vehicles, the Act amends the definition of investment management company (*Kapitalanlagegesellschaft*, "KAG") such that a KAG is no longer considered to be a credit institution. The primary effect of this change is that KAGs are no longer regulated pursuant to the German Banking Act (*Kreditwesengesetz*, "Banking Act") and, therefore, will be subject to less exacting regulatory standards more in line with regulation in other European countries. The German Legislature (*Bundestag*) notes in its statutory explanation of the change that the previous regulation may have had a detrimental effect on the German fund industry. Consequently, the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, "BaFin") assumes full regulatory responsibility over KAGs, whereas previously they were also subject to regulatory supervision by the Deutsche Bundesbank.

An additional change to the regulatory scheme is that the start-up capital required to operate a KAG is reduced from €730,000 to €300,000 pursuant to Section 11 of the Act. Further, the required start-up capital may be reduced by an additional fifty percent if a credit institution or insurance company issues a financial guarantee on behalf of the KAG. However, the floor for the additional capital requirement of 0.02 percent of assets under management in excess of the floor is reduced under the Act from €3 billion to €1.125 billion.

Expedited Approval of Fund Rules

In an effort to make it quicker and easier to establish new funds, the Act limits BaFin's window for approving fund rules to four weeks. No explicit time window was contained in the German Investment Act prior to amendment. As before, BaFin is required to approve fund rules if

they comply with applicable statutory provisions. If BaFin does not issue a decision or a request for missing documents within the four-week window, approval is automatically granted. BaFin must provide written confirmation of the approval if requested. Further, with respect to UCITS-compliant funds, if the fund rules do not differ from a model set of rules pre-approved by BaFin, no separate approval from BaFin or waiting period is required. In this case, BaFin must still be notified of the fund or sub-fund's launch and provided with the rules, as well as the appropriate simplified and full prospectuses.

Formerly, an amendment to fund rules that was inconsistent with previous investment strategies had to be published at least 13 months prior to taking effect. Under the Act, this waiting period has been shortened to six months or such shorter period agreed to by BaFin. Again, this change is intended to allow for increased flexibility to respond to changing market conditions and to manage funds optimally. Only a one-day waiting period exists for consistent changes to fund rules.

No Material Changes To Outsourcing Regulations

Though outsourcing by KAGs was previously regulated pursuant to the Banking Act, the rules under the new Act are nearly identical. Under Section 16 of the Act, duties fundamental to the business operation of a KAG can still be outsourced in the interest of efficient management, provided that the outsourcing in no way interferes with the KAG's supervisory authority or prevents the KAG from acting in the best interests of investors. As further relief under the Act, KAGs now need only notify BaFin, at the end of their fiscal year, of all outsourcing agreements effected during that year. Separate notification for each outsourcing agreement prior to its signing is no longer required.

Risk management regulations issued by BaFin for credit institutions with respect to outsourcing will generally continue to apply to KAGs. The regulations, among other things, specify items required in an outsourcing contract. It is expected that the pre-approved contract forms with respect to the outsourcing of investment advice used prior to the implementation of the Act will still be valid.

Costs and Costs Transparency

Pursuant to the Act, KAGs are required to note in a fund's full sales prospectus that transaction costs are paid and that the fund's total expense ratio does not include transaction costs. KAGs must ensure that investors are not unduly negatively affected by transaction costs, for example, costs incurred when selling or redeeming shares. The legislators note that the Act purposefully avoids more detailed guidelines about the content of internal measures regarding transaction costs and that it is intended that KAGs will self-regulate with respect to their obligations to investors.

More Flexible Rules for Real Property Funds

The Act also allows greater flexibility for real property funds (*Immobilienfonds*). Previously, real property funds were not allowed to invest in real estate companies that held participations in other real estate companies. Both of these restrictions have now been removed, although an indirect participation as indicated above must be a 100% holding. Further changes include allowing thresholds for redemptions above which the fund's KAG need only accept redemption requests monthly and may require up to twelve months' notice prior to such redemption. Additionally, valuation of assets prior to purchase must now be undertaken by an independent expert.

Infrastructure Funds

The Act introduces infrastructure funds (*Infrastruktur-Sondervermögen*). The purpose behind the introduction of infrastructure funds is to make investments in public-private partnerships ("PPPs") available to retail investors.

Infrastructure funds may invest in standard asset types such as stocks and money market instruments. In addition, infrastructure funds may invest in interests in project companies of PPPs, usufructuary rights in property, and property being used for public purposes. Such additional investments must constitute at least 60% of an infrastructure fund's net asset value. Investments in usufructuary rights or permissible property together may not exceed 30% of a fund's net asset value, and a single such investment may not exceed 10% of a fund's net asset value. Infrastructure funds may not invest in derivative instruments.

For funds for retail investors, interests in PPPs may be purchased only after construction or renovation has been completed (i.e., when the company is operational). The value of the investment must also be confirmed by an auditor. Interests in PPPs may not exceed 80% of a fund's net asset value. No more than 20% of a fund's investments may be invested in stocks. As above, investment in a single stock or interest in a PPP may not exceed 10% of a fund's net asset value.

The sales prospectus of an infrastructure fund must include, among other disclosures:

- a description of the basic characteristics of PPPs;
- types of PPPs in which the fund may invest and its methodology for choosing PPPs in which to invest; and
- disclosure that the fund may invest in PPPs that do not belong to a stock exchange or other organized market.

Fund shares must be subject to redemption at least annually, but no more frequently than semi-annually. Further, redemption may only be requested for investments under €1 million.

Microcredit Funds

The Act also introduces microcredit funds, also called "other funds" (*sonstige Sondervermögen*). In addition to standard investments in stocks and money market instruments, microcredit funds may invest in non-securitized receivables from money loans, precious metals and derivatives. Investment in these three types of assets must not exceed, in aggregate, 30% of a fund's net asset value. Allowing investment in non-securitized receivables from money loans is intended to open up the micro and consumer credit industries to funds.

Microcredit funds may also invest in any company with an assessable value, including companies that are not listed on an exchange. The term "company" is used loosely in the Act, and includes structures such as trusts and partnerships. Microcredit funds may invest up to 20% of their net asset value in companies.

Notwithstanding the above investment limits, microcredit funds may invest up to 75% of their net asset value in non-securitized receivables from money loans issued by domestic or foreign microcredit institutions properly supervised in their home country. In order to meet this characterization, microcredit loans must be borrowed solely for business purposes. Other than the €1 million exception, redemption rules regarding infrastructure funds also apply to microcredit funds.

As with infrastructure funds, a microcredit fund's sales prospectus must include, among other disclosures, certain disclosures regarding the types of non-securitized receivables, derivatives and precious metals it may invest in and how it invests in them.

Investment Stock Corporations

Investment Stock Corporations, introduced in 2004, have not been utilized to the extent that was hoped. As a result, the Legislature introduced sweeping changes in the Act in the hope of spurring increased use of this vehicle. Changes include the separation of corporate shareholders who established the corporation and have participation and voting rights at meetings, and investment shareholders who are shareholders for investment purposes only and thus do not hold participation or voting rights, unless such rights are otherwise granted in the articles of association.

Also of particular importance, investment stock corporations can now be organized as funds compliant with the UCITS Directive and, thus, are now subject to the rules and regulations for such funds as opposed to the rules for noncompliant funds. As such, investment stock corporations can also be structured as umbrella funds, which previously had not been possible.

While the initial minimum capital requirement remains €300,000 under the Act, they are now additionally required to have a stock capital of at least €1.25 million within six months of registration in the commercial register. Additionally, investment stock corporations can now be managed by KAGs.

Finally, the previous distinction between investment stock corporations with variable capital and those with fixed capital has been abolished under the Act. The category of investment stock corporations with fixed capital has never been used since it was established.

Special Funds

Rules regarding special funds (*Spezialfonds*) are also liberalized and simplified in the Act. Special funds continue to be available only to institutional investors. The Legislature noted that the lesser need for statutory protection for institutional investors contributed to the decision to simplify these rules, for instance, the relaxation of certain reporting requirements (for example, special funds are no longer required to intermittently submit changes to data submitted in a semi-annual report). A professed goal in liberalizing special fund requirements was to make German institutional investment offerings comparable to those available in other countries, notably, Luxembourg.

Among the most important changes is the elimination of the various investment restrictions that had previously applied to special funds, though

special funds are still subject to certain restrictions, including the need to undergo a risk limitation analysis prior to investing in derivatives. A further important change is the elimination of the 30-investor maximum that previously applied to special funds. Under the Act, there is no maximum for the number of investors, although funds must have no more than one hundred investors in order to qualify as special funds for investment tax purposes. Additionally, special funds are now permitted to engage in short-term borrowing of up to 30% of their asset value.

Changes Applicable to Foreign Funds

Definition of Foreign Investment Units

Under the German Investment Act prior to amendment, and the applicable guidance, there was some uncertainty regarding whether closed-ended funds met the definition of foreign investment unit. While the interpretive guidance issued by the Federal Ministry of Finance regarding the definition had been read to include closed-ended hedge funds, the inclusion of closed-ended mutual funds depended on a case-by-case analysis of whether such fund fell within the definition of a "security" within the meaning of the German Securities Prospectus Act (*Wertpapierprospektgesetz*), an "interest" within the meaning of the German Sales Prospectus Act (*Verkaufprospektgesetz*), or an "investment unit" within the meaning of the German Investment Act. In the Act, the definition of investment unit has been expanded to include both closed-ended hedge funds and closed-ended mutual funds in every case, subject to the condition that closed-ended funds must be subject to sufficient investment supervision in their home jurisdiction in order to meet the definition.[1] Unregulated foreign closed-ended funds that previously met the definition of foreign investment unit no longer meet the definition and are, therefore, no longer subject to supervision pursuant to the Act. Such closed-ended funds will still need to satisfy the relevant provisions of the Securities Prospectus Act or Sales Prospectus Act, as applicable.

[1] The new definition reads as follows: "Foreign Investment Units shall mean units in foreign investment asset pools which are issued by an enterprise that has its seat abroad (foreign investment company), and from which investors can request redemption, or from which investors have no right to request redemption but which is regulated by a supervisory body for collective investment pools in the country in which it is seated." Section 2(9), Investment Act.

Private Placement

Private placement rules have been clarified under the Act to provide greater guidance regarding what is and what is not to be considered a private placement in Germany. The general rationale for these clarifications is that institutional investors, as knowledgeable parties, do not require the protections afforded by the regulations in respect of public offers.

German law does not provide a legal definition of public placement. Prior to the Act, a private placement was considered, by regulation, to be an offer made to a limited number of private and/or institutional investors who do not require the investment protection provided by a prospectus. Though this general definition is still accurate under the Act, the Act provides further contours to the definition by identifying certain actions that will not be considered public offers (i.e., that are private placements). Also under the Act, previous rules that required a prior relationship between the targets of a placement and the offeror are no longer valid. Further, an offeror is no longer required to individually approach addressees on the basis of individual criteria in order for an offer to constitute a private placement, as had previously been the case.

Actions that the Act identifies as not constituting public offers include:

- marketing shares to institutional investors, including:
  - Credit institutions
  - Public and private insurance companies
  - Investment management companies ("Kapitalanlagegesellschaften")
  - Investment stock corporations ("Investmentaktiengesellschaften")
  - Foreign investment companies and their authorized management companies
  - Pension funds and their management companies
- referencing or naming non-registered investment funds;
- publishing issue and redemption prices;

- referencing non-registered sub-funds of umbrella funds in sales documentation if at least one sub-fund of such an umbrella fund is registered and the sales document indicates that any non-registered sub-fund will not be publicly distributed;

- publishing data pursuant to Section 5 of the German Investment Tax Act (*Investmentsteuergesetz*) (regarding the amount of any distributions and relevant tax implications);

- including in a prospectus information pursuant to Section 7 of the Securities Prospectus Act (*Wertpapierprospektgesetz*) (regarding data required in a prospectus pursuant to Directive 2003/71/EC of the European Parliament). This is particularly relevant with regard to prospectuses of hedge fund linked notes or certificates that require a description of the underlying hedge fund; and

- with regard to shares of foreign investment funds traded on a German stock exchange, publishing any information required by the rules of that stock exchange if no public distribution as defined in the Investment Act occurs.

The Act also authorizes BaFin and the German Bundesbank to issue further guidance on private placements versus public offers. Though such guidance has yet to be released, it is generally expected that it will be issued in the near future.

Consistent with the rationale separating investors based on their knowledge levels, it will not be considered a private placement if an institutional investor purchases shares from an offeror on behalf of retail investors. It will however be considered a private placement if an institutional investor purchases shares on behalf of or elicits purchases from other institutional investors. In other words, the characterization depends on whether an institutional investor is the ultimate purchaser.

UCITS

The Act contains a number of changes with respect to notifying BaFin of the public distribution of foreign UCITS in Germany. The general purpose behind these changes regarding UCITS is to modernize the German foreign UCITS scheme by bringing it in line with the Eligible Assets Directive and the Committee of European Securities Regulators ("CESR") guidelines. The effect of the change is a significant simplification of the notification procedures. In connection with the amendments relating to notification for UCITS, BaFin issued additional guidance on 7 January 2008 (the "Guidelines").

Under the Act, BaFin was given discretion to adopt an electronic notification procedure, but, as noted in the Guidelines, it has declined to do so. In the Guidelines, BaFin also adopted a procedure that provides for notification in English. Further, though UCITS are still subject to a two-month waiting period prior to registration, BaFin is authorized to shorten the waiting period if there is no apparent reason why public distribution will be disallowed. On the other hand, BaFin is authorized to interrupt the waiting period if it appears that public distribution will be prohibited. If the complication is resolved, the interruption can be lifted and the waiting period resumed. If a foreign fund waives its right to publicly distribute shares in Germany, this waiver must be published in the electronic federal gazette. The waiver is also subject to a deregistration fee. These requirements regarding a waiver are not applicable, however, to certain mergers or liquidations of foreign UCITS which have the effect that they no longer exist in their home country.

An additional change in the Act is that sub-funds of foreign UCITS that are organized as umbrella funds may be registered for public distribution even if not all sub-funds of such an umbrella fund are registered. In other words, an umbrella fund may market certain sub-funds without being required to market all sub-funds. An umbrella fund's full and simplified prospectuses must note that the sub-funds not being offered are not available in Germany. The rules and exceptions regarding waivers of the right to public distribution in Germany also apply to individual sub-funds.

Additionally, the legislature has made clear in the Act that only German language prospectuses will be binding. Finally, additional information specific to German investors, which had previously only been required in the full German prospectuses, is now also required in the simplified prospectus. Both of these changes are intended to better protect investors' best interests.

Hedge Funds

Though the legislature has endeavored to increase the flexibility of fund offerings in Germany, the Act does not contain many changes regarding hedge funds. One important change has been made with regard to the role of prime brokers. Although the use of a prime broker is already permissible for domestic single hedge funds under the current regulatory regime, the Act further clarifies the practical use of the prime broker by explicitly

stating that the safe custody of assets can be transferred to a prime broker. Such transfer can occur as long as this prime broker:

- has its seat in the European Union, the European Economic Area or a state that is a full member of the Organization for Economic Co-operation and Development (OECD);
- is subject to effective public supervision in its home state; and
- has adequate solvency.

According to the rationale of the Act, the new rules for prime brokers are designed to allow all currently prevalent models of prime brokerage. The prime broker can be mandated either directly by the investment company or via the depositary bank. If a prime broker is used to hold assets, additional risk disclosure must be added to a fund's sales prospectus.

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