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CLIENT ALERT

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IMPLICATIONS OF THE AMENDMENT OF THE GERMAN INVESTMENT ORDINANCE IN RELATION TO PRIVATE EQUITY AND REAL ESTATE FUNDS

On 25 July 2008 the German Federal Ministry of Finance submitted the draft ordinance on the Amendment of the German Ordinance on the Investment of the Restricted Assets of Insurance Companies *(Investment Ordinance* – **"InvO"**) to interested industry associations. The Ministry invited the associations to comment on the draft by 11 September 2008. The entry into force of the amended Investment Ordinance is expected shortly after completion of the consultation, but in any event in the course of this year.

Below we summarize the practical implications for German insurance companies investing in private equity and real estate funds and for the managers of such funds.

1. CLOSED ENDED FUNDS

The Investment Ordinance provides for a list of assets that are eligible for an investment by insurance companies which can be allocated to its restricted assets. The investment in closed ended funds is generally characterized as a participation in an enterprise pursuant to sec. 2 subs. 1 no. 13 InvO.

1.1 Lifting of the participation quota

Together with subordinated loans pursuant to sec. 2 subs. 1 no. 9 lit. a InvO investments in participations in enterprises (sec. 2 subs. 1 no. 13 InvO) must not exceed 10 percent of the restricted assets of the investing insurance company (so called participation quota). In the new Investment Ordinance this restriction would be lifted to 15 percent (sec. 3 subs. 3 sent. 3 InvO). In addition the participation quota will not take into account subordinated loans to Banks with their legal seat in a member state of the EEA. Such loans will no longer be calculated against the participation quota.

1.2 Abolishment of the 10-percent-threshold

The abolishment of the restriction on investments by an insurance company in more than 10 percent of the equity of an enterprise in the meaning of sec. 2 subs. 1 no. 13 InvO should also have significant relevance for the investment in closed ended funds. This so-called "10-percent-threshold" will be replaced by the requirement that no single investment in an enterprise must account for more than 1 percent of the restricted assets (sec. 4 subs. 4 sent. 1 InvO).

For purposes of calculating this new limitation the so-called "holding privilege" applies, similarly as for the calculation of the 10-percent-threshold.

1.3 Modification of the holding privilege

Pursuant to amended sec. 4 subs. 4 sent. 3 InvO, the 1 percent limitation in relation to restricted assets relates to the assets of a holding company, calculated on a look through basis, provided that the sole purpose of the holding company is the holding of investments in subordinated loans (sec. 2 subs. 1 no. 9 InvO), listed stock (sec. 2 subs. 1 no. 12 InvO) and participations in other enterprises (sec. 2 subs. 1 no. 13 InvO). This constitutes a significant extension of the scope of the holding privilege. The existing holding privilege only provides for a look through in the case of holding companies the sole purpose of which was the holding of "participations" in other companies. This prohibits pursuant to the interpretation of BaFin the look through in cases where the holding company holds instruments other than equity participations. Clearly, this is an issue especially for mezzanine funds (see Weiser/ Cohn-Heeren Absolut|report Nr. 31, April 2006). This material disadvantage will not apply in the case of the new "1-percent-threshold".

2. OPEN ENDED FUNDS AND THE REAL ESTATE QUOTA

For real estate funds it is usually not feasible to offer a redemption right to investors.

Not only with a view to attracting insurance companies as investors, non-German real estate funds, however, do offer a redemption right to investors in order to facilitate an investment as an investment in a foreign investment unit in the meaning of sec. 2 subs. 1 no. 17 InvO.

By investing in a foreign investment unit, rather than in a participation in an enterprise, the participation quota is spared and the investment can be counted against the so-called "real estate quota" pursuant to sec. 3 subs. 5 InvO. The real estate quota permits an investment of up to 25 percent of restricted assets in real estate, real estate holding companies, REITs and units in regulated real estate funds.

An eligible investment pursuant to the amended sec. 2 subs. 1 no. 17 InvO requires that the units are issued by an investment company having its seat in the EEA and which is regulated for investor protection purposes. Further, the fund must be subject to requirements which are comparable to those of German funds and Spezialfonds under the German Investment Act.

Spezialfonds have been explicitly included into the stipulations of sec. 2 subs. 1 no. 17 InvO (by reference to 2 subs. 1 no. 15 InvO). This should serve to clarify that the so-called "comparability test" can be applied with reference to the provisions applicable merely to Spezialfonds, provided the foreign fund qualifies as a Spezialfonds, i.e. does not admit individuals as investors. While this provides some flexibility in structuring, inter alia sec. 82 subs. 3 of the German Investment Act, which provides that the assets of the fund may not be charged for amounts exceeding 50 percent of their NAV, may not be waived.

In this context the following two issues are also noteworthy:

(i) Investment in real estate holding companies are also calculated against the real estate quota. Real estate holding companies are companies the sole purpose of which is the acquisition, development and management of real estate. The amended Investment Ordinance will not have the restriction pursuant to which a real estate holding company may hold only three assets. Funds with an acquisition and holding structure that permits direct holdings of real estate should have some structuring potential to qualify for the real estate quota even as a closed ended fund.

(ii) Pursuant to sec. 2 subs. 1 no. 4 InvO shareholder loans to real estate holding companies are an eligible asset under the amended Investment Ordinance, provided the requirements of sec. 69 of the Investment Act are observed. Such shareholder loans are also allocated to the real estate quota.

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