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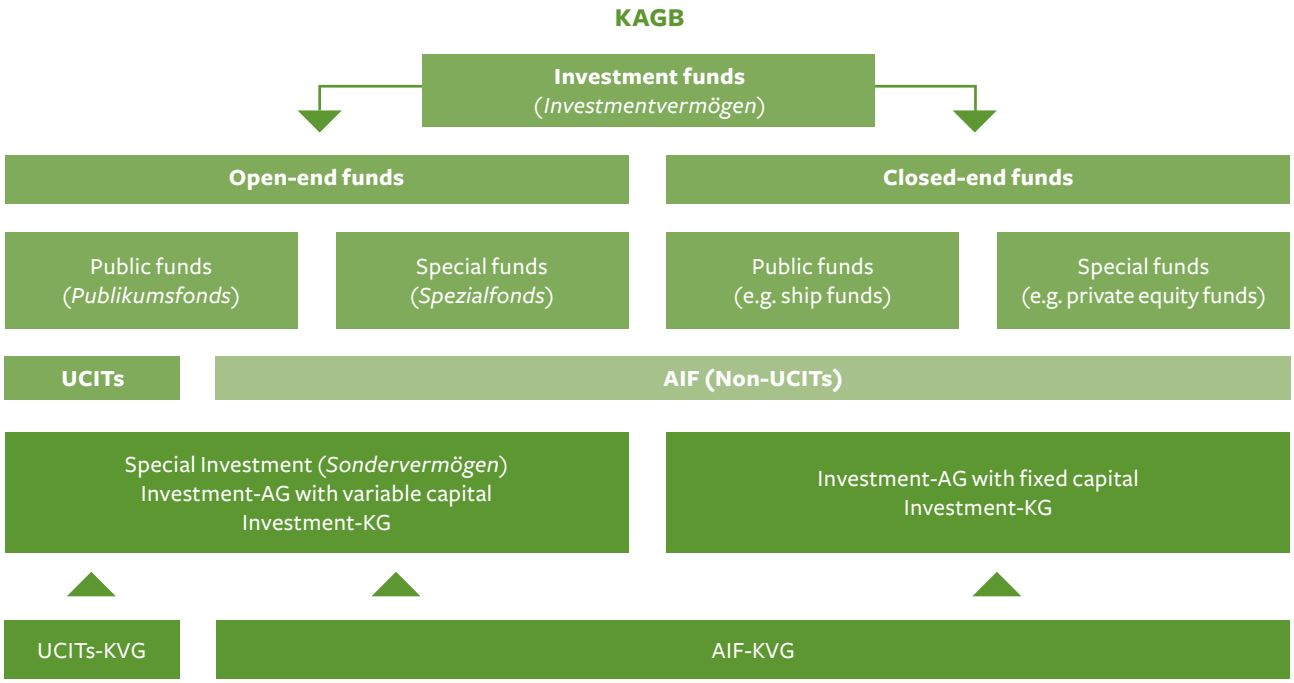
The Implementation of the AIFM-Directive in Germany – What Third Country Managers should know

The new German Capital Investment Act (*Kapitalanlagegesetzbuch, "KAGB"*) enters into force on July 22, 2013. The KAGB will replace the Investment Act (*Investmentgesetz, "InvG"*) and is supposed to regulate, for the first time, the entire German investment law. While the AIFM Directive (*"AIFMD"*) aims at creating a harmonized regulatory framework and an internal market for the managers of alternative investment funds, the German legislator implemented the AIFMD in the KAGB thereby creating a cohesive set of rules for all open- and closed-end funds and their managers in Germany. Unlike other European legislators such as the Luxembourgian, the German one goes beyond the goals of the AIFMD and provides for a comprehensive regulatory framework for all domestic fund products. In addition to the KAGB, the Commission's Delegated Regulation (EU) No 231/2013 of December 19, 2012 applies. As a Level 2 measure it supplements the AIFM Directive. Further Level 2 measures will become effective by July 22, 2013, which is the latest date on which the member states must have implemented the AIFMD (Art. 66 AIFMD).



Investment funds in accordance to the KAGB

Sphere of Application

The KAGB applies when there is an "investment undertaking" as laid down in Sect. 1 para. 1 KAGB. The investment undertaking, therefore, is a central concept of the future German investment law. In accordance with Art. 4 para. 1 (a) of the AIFMD, the KAGB defines investment undertakings rather broadly: An investment undertaking is "any entity for collective investment which collects capital from a number of investors in order to invest it following a defined investment strategy for the benefit of these investors, and which is no operating company outside the financial sector."

The recently published paper of BaFin from June 14, 2013 (http://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Auslegungsentscheidung/WA/ae_130614_Anwendungsber_KAGB_begriff_invvermoegen.html) indicates how BaFin will interpret the individual elements of this definition.

The term "**entity**" comprises all legal forms (partnerships, companies limited by shares, funds), regardless of the type of investor participation (equity instruments, participation rights, or bonds). However, individual relationships (such as they exist in managed accounts) or parallel participations of investors that do not have an organizational relationship with each other (such as club deals) are not included.

The expression "**for collective investment**" means that the investor participates (also to a limited extent) not only in the profits but also in the losses of the invested assets. Instruments granting a fixed claim to payment or an unconditional claim to capital repayment must be differentiated from this (for instance, bonds or deposits). "Collecting capital from a number of investors" comprises not only direct and indirect steps to raise capital from one or more investors, but also any commercial communication aiming at raising capital. A "**number of investors**" is already given if the number of investors is not limited to one investor (Sect 1 para. 1 sentence 2 KAGB), even if there is in fact only one investor. Furthermore, the entity must invest the collected capital "**following a defined investment strategy**". This requires that the criteria according to which the capital is supposed to be invested are more specific than a

general company strategy or the financing of a general business activity. The opportunities given to the management company must be restricted in the investment conditions, the articles of association or the partnership agreement.

The interpretation of the investment attribute "**for the benefit of the investors**" still needs clarification. From BaFin's perspective, this attribute is not fulfilled if the monies collected are used in-house. This is the case if, among other things, the issuer is not obliged to invest in assets based on an internally generated index or reference portfolio, or if the interest of the repayment amount is determined or calculable by a formula or a composition of the underlying assets on which the provider has no more leeway in decision-making after the transfer of the monies. Additionally, this interpretation provides for numerous questions of definition, for instance how to include swap-based ETF in the concept of investment undertakings when the issuer does not invest in the index values and has no influence in the composition of the index.

The negative defining attribute that the entity may not be "**an operating company outside the financial sector**" is, in a way, the backside of the attribute "defined investment strategy". It allows companies that operate facilities for renewable energy without outsourcing them, run a business (e.g., a hotel) situated on a land plot, or store raw materials to be exempt from the KAGB. Based on this defining attribute, the question must be answered whether or not real estate corporations and REITs can be considered investment undertakings in accordance with Sect. 1 para. 1 KAGB. BaFin answers this in affirmative with regard to German REIT corporations. Within the concept of investment undertakings, the KAGB differentiates between entities for the collective investment in securities (UCITS) pursuant to the UCITS-IV Directive (Sect. 1 para. 2 KAGB) and all other investment undertakings which are referred to as "Alternative Investment Funds" ("*AIF*") (Sect. 1 para. 3 KAGB). AIF, again, can be open or closed investment undertakings (Sect. 1 para. 4 and 5 KAGB). What distinguishes them is whether or not investors may return their shares at net asset value at least once a year.

Important for product regulations and distribution specifications are further differentiations between public investment undertakings and special AIF, whose shares may be held only by semi-professional and professional investors (Sect. 1 para. 6 KAGB). With regard to the term "professional investor", the KAGB refers to Attachment II of the Directive on Markets for Financial Instruments (Sect. 1 para. 19 no. 32 KAGB), which specifically covers credit institutions, investment firms, insurance companies, investment corporations, large companies as well as governments and supranational institutions.

The concept of semi-professional investors refers to each investor who either

(i) invests at least EUR 200,000 and who, as certified by the capital investment company (*Kapitalverwaltungsgesellschaft, "KVG"*) or the placement agency, has the necessary experience to understand the investment risks or who

(ii) invests at least EUR 10 million.

While the repealed Investment Act (*Investmentgesetz, "InvG"*) was based on a formal investment concept according to which this Act only applied if the fund types provided for in the InvG were managed but all other fund products were permitted, the KAGB introduces a **substantive investment** concept. Consequently, the management of AIF that do not comply with the requirements of the AIFMD is inadmissible. But as the legislator also lays down restricting product regulations for AIF with regard to the available legal forms and the investment policy, the management of investment undertakings which do not comply with the requirements of the KAGB becomes an illegal investment transaction (see Sect. 15 para. 1 KAGB).

Entities explicitly exempt from the KAGB are holding companies, institutions providing for occupational pension schemes, certain state institutions and special purpose vehicle companies (Sect. 2 para. 1 KAGB). The KAGB does not apply, either, to family offices, insurance agreements, joint ventures and group-internal investment undertakings (Sect. 2 para. 3 KAGB).

Licensing requirements

Each company with its head office and central administration in Germany whose business activities aim at the management of investment undertakings on its own responsibility (not acting as an outsourcing company) is considered a KVG and requires approval by BaFin (Sect. 17 para. 1 KAGB). Depending on the type of managed investment undertaking, the KAGB differentiates between UCITS-KVG and AIF-KVG (Sect. 17 para. 1 KAGB). The KVG can be designated either as external KVG by or on behalf of the investment undertaking, or the investment undertaking manages itself autonomously as an internal KVG (Sect. 17 para. 2 KAGB). An investment undertaking is managed if at least the portfolio management or the risk management is rendered for an investment undertaking. It then requires an authorization. However, the authorization as a KVG cannot be granted if, among other things, the company renders the portfolio management, but does not render the risk management, or vice versa (Sect. 23 no. 10 KAGB). For the management of UCITS or AIF individual admission procedures are provided for as a KVG; however, reliefs apply if both admissions are aimed at (Sect. 21 para. 5 KAGB).

The legislator arranged the content of the applications for authorization for UCITS-KVG and AIF-KVG almost identically. This concerns aspects such as proof of initial capital, information on the managing directors and owners of important participations, presentation of a business plan including a description of the organization and control procedures, and a presentation of the company agreement of the KVG (Sect. 21 para. 1 and Sect. 22 para. 1 KAGB). Moreover, an AIF-KVG must provide comprehensive information on its outsourcings, remuneration policy, depositary, its investment strategies and the managed AIFs (Sect. 22 para. 1 no. 8 et seq. KAGB). Despite the requirement to hand in extensive documentation, the review period of BaFin is generally three months for a complete application for an AIF-KVG, while it is six months for an UCITS-KVG (Sect. 21 para. 2 and Sect. 22 para. 2 KAGB). For AIF-KVG, a two-step procedure is possible: While permission can be granted to the AIF-KVG already upon completion of the information on the KVG or investment strategies (Sect. 22 para. 3 KAGB), the management of AIF may be started no earlier than one month after the subsequent submission of AIF-specific and other documents (Sect. 22 para. 4 KAGB).

It must be clarified how this two-step procedure impacts on the requirement to approve the investment conditions of newly launched AIF: While the investment conditions of public AIF must be reviewed within four weeks (Sect. 163 para. 2 KAGB), the investment conditions of special AIF only require submission to BaFin, i.e., they do not have to approved (Sect. 273 sentence 2 KAGB). This contradiction could be resolved in a way that the one-month waiting period associated with the two-step procedure only applies to first-time AIF that must be allocated to a specific investment strategy.

BaFin specified in a bulletin the individual documents for an AIF-KVG, particularly as regards the suitability of the managing directors. However, there is no indication whether the managing directors of closed fund vehicles have the necessary expert knowledge for a position as a managing director of an AIF-KVG. Until now, they were usually not employed by a regulated company. In these cases it seems appropriate that the application for admission contains a plausible explanation by the managing directors how they will acquire the necessary theoretical and practical skills in the first time of their employment; this, however, should not be a hindrance to granting the approval as an AIF-KVG for closed AIF. The so-called “small KVG” does not require approval, but only registration (Sect. 44 para. 1 KAGB). They comprise, inter alia, those KVG that (i) manage exclusively special AIF and whose managed investment undertakings (incl. leverages) do not exceed EUR 100 million or (ii) whose assets (without leverage) do not exceed EUR 500 million and which do not grant their investors any return rights within the first five years (Sect. 2 para. 4 KAGB). This also concerns KVG that manage exclusively domestic closed AIF and whose assets (incl. leverage) do not exceed EUR 100 million (Sect. 2 para. 5 KAGB).

Supervisory requirements on the KVG

The KAGB imposes a great number of ongoing supervisory requirements on the KVG regarding their organization and conduct, parts of which correspond to existing specifications to capital investment companies in accordance with the repealed Invest-

ment Act and the Investment Conduct and Organization Directive (*Investment-Verhaltens- und Organisationsverordnung, "InvVerOV"*). Particularly the unregulated managers of closed fund vehicles (with the exception of small KVG) face a considerably increasing intensity of regulation. The supervisory requirements apply equally on UCITS-KVG and AIF-KVG. The supervisory requirements on AIF-KVG are specified in the EU Regulation. Each KVG is obliged to perform its tasks solely in the interest of the investors and independent of the depository (Sect. 26 para. 1 KAGB in conjunction with Art. 18 EU Regulation).

The content of this principle and the provisions resulting from it concerning diligence, special knowledge, a fair treatment of investors and maintaining the integrity of the market are identical with the previous provisions laid down in the repealed Investment Act and the InvVerOV. A new factor is the legal emphasis that a misuse of market practices (e.g., late trading or market timing) must be prohibited (Sect. 26 para. 6 KAGB in conjunction with Art. 17 EU Regulation). Regarding the choice of assets, stricter requirements going beyond the provisions of the InvVerOV apply to the investment in restricted liquid assets, for instance that a business plan or investment plan must be drafted, the term of the assets must be in accordance with the duration of the funds, and the transaction must be analyzed in advance regarding its risks and all legal, tax, financial and other value-related factors and potential sales options (Art. 19 EU Regulation). For KVG of closed AIF, this results in an increased documentation and review effort prior to the actual investment. To protect the investors, the KVG must take any measures to identify, prevent, settle and monitor all conflicts of interest (Sect. 27 para. 2 KAGB in conjunction with Art. 30 et seq. EU Regulation).

The regulations basically correspond to the provisions applicable to capital investment companies laid down in the repealed Investment Act and the InVVerOV, but they are more detailed. Express provisions regarding the treatment of conflicts of interest in connection with the return of shares to AIF are new (Art. 32 EU Regulation).

The organizational tasks of KVG comprise an appropriate risk management and complaint system, the necessary resources, provisions on personal businesses, an extensive documentation, and appropriate control procedures, including the development of an internal audit and a compliance function (Sect. 28 para. 1 and 2 KAGB in conjunction with Art. 57 et seq. EU Regulation). In this regard as well, the requirements correspond to the core of the previous provisions laid down in the repealed Investment Act and the InvVerOV. An organizational focus of the KVG is the development of a risk management system and a risk controlling function which is independent of the operational area and must be separated from it (separation rule).

The risk management system must be capable of identifying, measuring, controlling and monitoring the essential risks of each investment strategy (Sect. 29 para. 2 KAGB). Thus, there are no significant differences from the obligations arising from the repealed InvG and the InvVerOV. Furthermore each managed AIF is required to have an appropriate liquidity management system (with the exception of closed AIF without leverage) (Sect. 30 para. 1 KAGB). The KVG must monitor the liquidity risks to ensure that the liquidity profile of the investments is in line with the underlying liabilities of the investment fund in consideration of the investment strategy and the principles of return; this must be ensured by stress tests (Sect. 30 KAGB in conjunction with Art. 47 et seq. EU Regulation). This requirement is also already known from the repealed InvG and the InvVerOV. Also, AIF-KVG have to define a remuneration system for their managing directors and for employees whose activity has a considerable influence on the risk profile (risk bearers), who exercise a control function or whose total remuneration is equivalent to that of the managing directors and risk bearers (Sect. 37 para. 1 KAGB). This measure aims at replacing remuneration systems enabling short-term profits by accepting high risks with remuneration systems that have a long-term orientation.

The remuneration system may not offer incentives for taking risks that are incompatible with the risk profile and the investment conditions. Attachment II of the AIFMDprovides further detail on the requirements on the remuneration system, *inter alia*, with regards to the long-term orientation, the relevant remuneration factors, and the arrangement of variable remuneration components. As a result, the KVG must adapt themselves to a remuneration

system similar to that laid down in the Instituts-VergV for credit und financial services institutions. The KAGB also provides for extensive provisions for the assessment of assets for all types of investment undertakings and requires the development of internal valuation guidelines (Sect. 168 et seq. KAGB in conjunction with Art. 67 et seq. EU Regulation, Sect. 271, 278, 286 KAGB).

The valuation can be done by an independent, external evaluator or – if the evaluation is done functionally independent – by the AIF-KVG itself or the depository (Sect. 216 para. 1 KAGB). The proposal made by the *Bundesrat* (German Federal Council) to consider committees of experts as evaluators in accordance with the provisions of the repealed Investment Act, was rejected by the *Bundestag*. With regard to closed public AIF, stricter requirements apply for the first evaluation of assets. In these cases, it is mandatory that the evaluation is done by an external evaluator. The purchase price of tangible assets may not or only marginally exceed the established value (Sect. 261 para.s 5 and 6 KAGB). The requirements applicable on UCITS and AIF-KVG regarding the outsourcing of tasks to another company (outsourcing companies) have been increased, compared to the requirements laid down in the InvG (see Sect. 16 InvG) (see Sect. 36 para. 1 KAGB in conjunction with Art. 75 et seq. EU Regulation).

The KVG must particularly be able to justify its entire outsourcing structure based on objective reasons (Sect. 36 para. 1 no. 1 KAGB). Compared to the previous legal situation, the KVG will face a higher documentation effort: on the basis of criteria such as the optimization of business functions, cost savings, specialist knowledge of the outsourcing company and/or specific relationships and approaches of the outsourcing company, it must provide a detailed description and proof of its reasons for outsourcing (Art. 76 EU Regulation). The EU Regulation contains specific requirements on the resources of the outsourcing company and the experience and reputation of the persons entrusted with the outsourced tasks (Art. 77 EU Regulation). Contrary to what was laid down in the repealed Investment Act, outsourcing must now be previously announced to BaFin (Sect. 36 para. 2 KAGB). Specific requirements apply when portfolio management and risk management are outsourced (Sect. 36 para. 1 no. 3 and 4 KAGB). They may by no means be outsourced to the depository, subdepository or another company having a conflict of interest (Sect. 36 para. 3 KAGB). They only can be outsourced if the outsourcing company is admitted or registered to render asset management or financial portfolio management and is subject to a supervisory authority, or – if the outsourcing company does not comply with these requirements – if BaFin approves the outsourcing nonetheless.

As a consequence, particularly UCIT management companies, external AIF-KVG, credit institutions and investment companies being authorized to render portfolio management may be considered as outsourcing companies (Art. 78 para. 2 EU Regulation). Outsourcing is not possible in an extent that the KVG becomes a letter-box company and cannot be considered as a management company any longer (Sect. 36 para. 5 KAGB). By listing specific circumstances, the EU Regulation attempts to specify the threshold above which an inadmissible outsourcing has to be assumed. These circumstances include, e.g., a missing specialist knowledge and resources for an effective monitoring of the entrusted tasks, the loss of the management function or the contractual rights to inspection, access or instructions, or a clear exceedance of the entrusted tasks compared to the tasks remaining with the KVG (Art. 82 EU Regulation). Nevertheless, considerable uncertainty remains in practice on the question whether previously successful business models such as the German Master-KAG (Master Capital Investment Company) can continue to exist on the same basis.

Depository

While the Investment Act so far referred to the term “depository bank”, the KAGB uses the term “depository” and differentiates between UCIT depositories and AIF depositories, as the AIFM Directive – contrary to the UCIT-IV Directive – contains detailed requirements for the depository. From a viewpoint of investor protection , the KAGB adopts some provisions of the AIFM depositories for the UCIT depositories (with regard to sub-deposit and the liability of the depository), but does not go beyond the previous regulations for depository banks pursuant to the Investment Act in order not anticipate the intended (and partly, stricter) provisions of the UCIT-V Directive for reasons of competition between the investment fund locations.

Each AIF-KVG must designate an AIF-depository for each AIF it manages (Sect. 80 para. 1 sentence 1 KAGB). Therefore, closed AIF are particularly and for the first time obliged to specify a depository. To designate a depository, a written agreement is required between the AIF-depository, AIF-KVG and, if necessary, the AIF (Sect. 80 para. 1 sentence 2 KAGB in conjunction with Art. 83 EU Regulation). Art. 83 EU Regulation contains a detailed catalogue on the minimum content of the depository agreement which comprises, among other things, a description of the services to be provided and the depository and supervisory function, the termination possibilities, a declaration on the liability of the depository, and regulations on the exchange of information. Besides credit institutions, also investment companies in accordance with the Capital Requirement Regulation (CRR-VO) with sufficient capital can act as AIF-depository (Sect. 80 para. 2 no. 1 and 2 KAGB). With regard to investment companies, a new type of new financial service to manage and deposit securities is created exclusively for AIF ("restricted depository services") so that they do not require approval as a credit institution (Sect. 1 para. 1a sentence 2 no. 12 German Banking Act (*Kreditwesengesetz ,"KWG"* new version). Furthermore, the legislator used the option provided for in the AIFM Directive that, with regard to closed AIF, a trustee (*Treuhänder*) (for instance, a notary public, an accountant or a lawyer) may take on the tasks of the AIF-depository in connection with his professional or business activity. As a prerequisite, the trustee (*Treuhänder*) must be subject to a professional registration that is legally recognized and mandatory, and to legal and administrative provisions or professional rules, and he must offer sufficient financial and professional guarantees in order to efficiently exercise the relevant tasks of an AIF-depository and, thus, fulfill the associated obligations (Sect. 80 para. 3 KAGB).

Such trustee (*Treuhänder*), however, may not deposit financial instruments eligible for safe deposit, as he would need a licence pursuant to the KWG. Something all AIF-depositories have in common is that at least one of their managing directors must have the required depository experience (Sect. 80 para. 9 KAGB). Whether or not the appointed trustee fulfills these requirements, must be decided case-specifically. It is to be expected that BaFin will soon publish criteria regarding the suitability of a trustee acting as depository. At first the AIF-depository deposits all financial instruments eligible for safe deposit of the AIF in a separate (blocked) account so that a clear identification is possible as to the belonging to the assets of the AIF (Sect. 81 para. 1 no. 1 KAGB in conjunction with Art. 89 para. 1 EU Regulation). With regard to assets not eligible for safe deposit (e.g., participations, real estate, unsecuritized receivables), the AIF-depository, based on information of the AIF or the AIF-KVG or a third party, is obliged to check whether or not the AIF or the AIF-KVG has effectively acquired ownership thereof, and to maintain and update written records (Sect. 81 para. 1 no. 2 KAGB). It must ensure that sufficient and reliable information is obtained, for instance an official proof of ownership (Art. 90 EU Regulation). The KAGB and the EU Regulation do not contain an obligation to go beyond the obtaining of all required information and to verify the correctness of the information.

A look-through approach applies not only to assets eligible for safe deposit but also to those not eligible for safe deposit: the obligations refer to the AIF-depository also with regard to assets in which investments are made through directly or indirectly controlled structures. This, however, is required only if the controlled structures do not dispose of a depository themselves (e.g., concerning funds of funds or master-feeder structures – Art. 89 para. 3 and Art. 90 para. 5 EU Regulation). The KAGB permits UCITS and AIF depositories to engage sub-depositors (Sect. 82 KAGB). This, at the same time, is the only admissible outsourcing activity of a depository (Sect. 73 para. 4 and Sect. 82 para. 4 KAGB). Depository tasks may be entrusted to a sub-depositor if this is not a circumvention of KAGB provisions, if there is an objective reason for the sub-depository (for instance, lower costs, asset must be deposited in the state of situs), if the sub-depositor was carefully selected and is examined regularly, and if the specialist knowledge, the organizational structures and the supervisory obligations of the sub-depositor correspond to the standard of a depository (Sect. 82 para. 1 KAGB). When selecting the sub-depositor, the depository must carry out an extensive legal and economic due diligence. Engaging additional sub-depositors in connection with the chain of depositors is admissible (Sect. 82 para. 3 KAGB). The controlling tasks of the AIF-depository (Sect. 83 KAGB in conjunction with Art. 85 et seq. EU Regulation) are identical with the

tasks of the UCITS-depository – which are already known from the depository bank – but go beyond them as regards the acquisition of real estate assets. More specific provisions on the control function of AIF-depositories are contained in the EU Regulation. Certain transactions of a public AIF are subject to reservations of consent by the AIF-depository which essentially correspond to the reservations of consent by the depository bank pursuant to the current Investment Act. They concern borrowings, charges, the investment of bank deposits at other credit institutions, and dispositions of real estate not eligible for safe deposit, real estate companies or tangible assets (Sect. 84 para. 1 KAGB).

For lack of a relevant provision in the AIFM Directive and the EU Regulation, these reservations of consent do not apply to special AIF. The depositories are subject to a strict liability regime. The depository is liable to the AIF or its investors regardless of fault for the loss of a financial instrument, no matter if the financial instrument was deposited by the depository or a sub-depositor (Sect. 88 para. 1 sentence 1 and para. 3 KAGB). For lost financial instruments, the depository must without delay return financial instruments of the same type or refund an appropriate amount of money. The only exception to this liability regardless of fault is if the depository can prove that the loss resulted from inevitable external events (e.g., natural disasters, state measures, war) and the depository had taken all appropriate countermeasures to safeguard against them (Sect. 88 para. 1 sentence 3 KAGB – Art. 101 EU Regulation). For any other losses, for instance occurring after an erroneous title examination of assets not eligible for safe deposit or consequential losses, the depository is only liable in case of intent or negligence (Sect. 88 para. 2 KAGB). The depository's liability also for a loss of financial instruments occurring at the sub-depositor constitutes a significant intensification of the current *culpa in eligendo* specified for cross-border depository in No. 19 para. 2 Special Conditions for Transactions in Securities.

The sub-depositor may only be exempt from its liability if (i) all prerequisites for a sub-depository are fulfilled, (ii) the investment undertaking or the KVG can assert the claim for damages on the basis of a written agreement between depository and sub-depositor directly vis-à-vis the sub-depositor (contract for the benefit of third parties pursuant to Sect. 328 German Civil Code [BGB]) and (iii) an agreement between the depository and the investment undertaking or the KVG stipulates the liability exemption and defines an objective reason (e.g., mandatory legal provisions of the third country to engage a local sub-depositor) (Sect. 88 para. 4 KAGB). If, due to local legal requirements, a local sub-depository must be engaged which does not comply with the requirements of the KAGB on the sub-depository, additional requirements apply for the purpose of liability exemption (Sect. 88 para. 5 KAGB). It is very questionable whether the depositories in practice will be capable of implementing the assumption of liability of the local sub-depositor. However, the termination possibilities to be provided for in the depository agreement are supposed to provide some protection against the assumption of inappropriate liability risks.

Product regulations

The product regulations of the KAGB vary significantly, depending on the type of investment undertaking. Funds and investment stock corporations with variable capital may be selected as the legal form of open investment undertakings, as was already stipulated in the Investment Act. If shares may be held only by professional and semi-professional investors, open investment limited partnerships may be selected as well. Provided the appropriate realization in the adaptable investment tax law, the introduction of this new legal form must be welcomed as it enables the tax-efficient bundling of internationally dispersed pension assets in a domestic investment vehicle.
For UCITS, basically the same rules remain effective that are known from the Investment Act for the funds that are in conformity with the Directive. In the area of open public AIF, the previous investment fund types – employee participation funds (*Mitarbeiterbeteiligungs-Sondervermögen*) and occupational pension funds (*Altersvorsorge-Sondervermögen*) will be cancelled without substitution for lack of practical relevance, and infrastructure funds will be permitted only as closed AIF. The other types of open public investment undertakings of the Investment Act will be adopted with partial (editorial) adaptations to the AIFM Directive and the KAGB. It is particularly noticeable that mixed investment undertakings (*Gemischte Sondervermögen*) and other investment

undertakings (*Sonstige Sondervermögen)* may, in the future, not acquire shares in real estate funds or hedge funds (Sect. 219 para. 1, Sect. 221 para. 1 KAGB), and that hedge funds may not invest in corporate participations any more (Sect. 221 para. 1 KAGB).

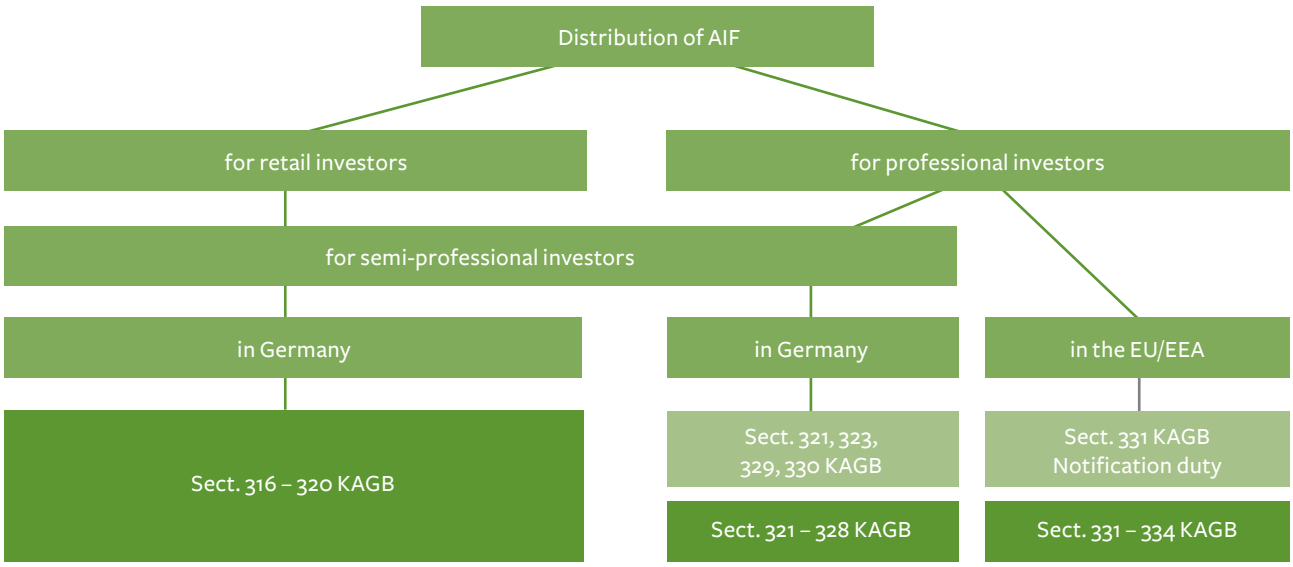
This means a severe change for both product types, which is unjustifiable. The legislator states that real estate funds and participations are illiquid investments and that hedge funds for private investors should for reasons of investor protection be acquirable only through funds of hedge funds. This explanation is not convincing. The investment decision for mixed and other investment undertakings concern AIF-KVG, which are considered professional investors and which dispose of an efficient risk management allowing them to handle the illiquid nature of real estate funds and participations as well as the risks associated with hedge funds. Moreover, these risks were limited by investment limits for mixed funds and other funds that were proven to be effective in practice and could have been easily adopted. Contrary to the draft paper for discussion of the KAGB, the open real estate funds category will be continued. In this context, however, the opportunity previously provided for in the *Anlegerschutz- und Funktionsverbesserungsgesetz ("AnsFuG")* will be canceled that investors may return amounts of up to EUR 30,000 per calendar half-year without a minimum holding or termination period. Instead, in the future shares can be returned only at a certain point in time once a year (Sect. 255 para. 2 KAGB).

The previous regulations continue to apply to all shares which were acquired prior to the KAGB becoming effective (Sect. 346 KAGB). For reasons of investor protection, shares in single hedge funds may in the future be held only by professional and semi-professional investors (Sect. 283 para. 1 KAGB). With regard to special AIF, the KAGB contains only minimum restrictions. No catalogue exists on admissible assets. It must only be ensured that they can be evaluated (Sect. 282 para. 2 KAGB). As required in practice, the special fund will be maintained in the form of an open domestic special-AIF with defined investment conditions. Generally, the regulations for open public AIF apply to it; however, deviations from it are possible (Sect. 284 KAGB). As regards closed AIF, the KAGB provides for a *numerus clausus*:

Closed AIF may be launched only as an investment company limited by shares with fixed capital or as investment limited partnership (Sect. 139 KAGB). The latter allows for a continuation in the usual GmbH & Co. KG structures of closed funds. It is not understandable why, for closed AIF, no provision is made to launch umbrella structures with various sub-funds, as it is possible for open AIF.

With regard to closed funds, there is the practical need to launch several products on the basis of one single fund vehicle serving as a platform. The necessity to establish a new investment company limited by shares or investment limited partnership for each product causes a considerable effort and disadvantages particularly small investors. Closed funds proved to be effective in an umbrella structure also abroad, for instance in Luxembourg. The KAGB contains a catalogue of admissible assets for closed public AIF (Sect. 261 para. 1 KAGB). This catalogue comprises tangible assets such as real estate, ships and aircraft, forest, containers, private equity participations, shares in closed AIF, securities, money market instruments and bank balances.

The catalogue of admissible tangible assets is not exhaustive but rather open for product innovations (Sect. 261 para. 2 KAGB). The risk was addressed as well that exists for closed funds when an investment is made in financial instruments to engage in investment management that requires approval (Sect. 1 para. 1a no. 11 KWG): the management of an investment undertaking now excludes investment management (Sect. 1 para. 1a no. 11 KWG new version). Further product restrictions exist for closed public AIF in the form of a maximum currency risk of 30 percent (Sect. 261 para. 4 KAGB), a maximum debt ratio of 60 percent (Sect. 263 para. 1 KAGB) and requirements on the risk-spreading (Sect. 262 KAGB). An adequate risk-spreading at least requires the investment in three tangible assets or, in economic terms, another spreading of the default risk. Investment undertakings without risk-spreading, i.e., particularly one-object-funds, are only admissible with a minimum investment sum of EUR 20,000 and the qualification of the investors as semi-professional investors (Sect. 262 para. 2 KAGB). No product regulations are defined for closed special-AIF. Therefore, the fact is sufficient that an evaluation of the assets is possible (Sect. 285 KAGB).



Distribution of AIF (without Sect. 330 a KAGB)

Public and special AIF that aim at the acquisition of control in an unlisted company have special reporting obligations when exceeding certain thresholds, and they have further obligations to protect the company and its employees upon the acquisition of control (so-called "private equity rules" – Sect. 287 et seq. KAGB).

The placement of shares in investment undertakings in Germany, be it shares in domestic AIF, EU-AIF, or AIF located in a third country (foreign AIF), principally requires a previous reporting of the placement intention to BaFin or a corresponding foreign supervisory authority, some of which requires extensive prospect and other information obligations. The placement to certain groups of investors (private placement) that previously was not subject to approval will be cancelled for UCITS and AIF. The extensive concept of placement laid down in the KAGB comprises any direct and indirect offering or placement of shares or stocks of an investment undertaking or the advertisement for an investment undertaking (Sect. 293 para. 1 sentence 1 KAGB). It is irrelevant if the offer or the placement are public. In compliance with the AIFM Directive, the concept of placement to semi-professional and professional investors, however, is defined more narrowly and requires that it takes place on the initiative of the management company or on its behalf and is aimed at this circle of investors (Sect. 293 para. 1 sentence 3 KAGB). It can be assumed from this that placement activities not based on the initiative of the management company fall under the so-called passive freedom to provide services. The KAGB adopts the provisions laid down in the Investment Act for the placement of UCITS in Germany with almost no modifications. The placement of domestic UCITS in Germany does not require any notification procedure. EU-UCITS are placed in a uniform manner for all investor categories on the basis of the European passport and in compliance with the requirements of the UCITS-IV Directive and the UCITS-V-DVO (Sect. 310 para. 1 KAGB). Unlike the placement of UCITS, the placement of AIF to investors in Germany will be completely redesigned. The placement of a domestic public AIF by an AIF-KVG requires a notification procedure which must be completed no later than 20 working days after the complete notification at BaFin (Sect. 316 KAGB). For all cross-border cases, the legislator requests for the admissibility of the placement to private investors that the AIF and the management company must be located in the same country (Sect. 317 para. 1 no. 1 KAGB). This request is justified with the risks arising from cross-border management of public AIF in view of a missing product harmonization. This does not conflict with the possibility of AIF-KVG and AIF management companies to manage AIF in another member state or a third country (European passport or third-country passport for management companies, see Sect.s 53 et seq. KAGB). It should be noted that if use is made of this passport, a domestic placement of AIF to private investors is excluded. Special conditions of admissibility apply for the

placement of EU-AIF to private investors. The EU-AIF management company and its management of the EU-AIF must comply with the requirements of the AIFM Directive; a representative and a paying agent in Germany must be designated; a depository must be appointed; moreover, the investment conditions or partnership agreements of the EU-AIF must contain regulations like those for comparable domestic AIF (Sect. 317 para. 1 KAGB). After submission of the complete notification to BaFin, a three-month processing period applies (Sect. 320 para. 2 no. 1 KAGB). The admissibility of the placement of foreign AIF furthermore requires that, (i) agreements between BaFin and the foreign supervisory authorities exist with regard to the cooperation, the efficient information exchange and the monitoring of systemic risks (cooperation agreements), (ii) the state of origin may not appear on the list of the non-cooperative countries of the Financial Action Task Force and (iii) effective agreements must have been concluded with the state of origin of the AIF regarding an efficient information exchange in tax matters (tax agreements) (Sect. 317 para. 2 KAGB).

In the following text, aspects (i) to (iii) will be referred to as "requirements on third countries". The period for processing the notification of foreign AIF is six months (Sect. 320 para. 2 no. 2 KAGB). The processing time will reduce to three months after the introduction of the third-country passport (probably end 2015). A notification to BaFin is required for the placement of special AIF or EU-AIF to professional and semi-professional investors by an AIF-KVG (Sect. 321 KAGB). The same applies to the placement of foreign AIF after introduction of the third-country passport. Here, it is mandatory that the requirements on third countries of the AIF must be fulfilled and the AIF be managed in compliance with the AIFM Directive (Sect. 322 KAGB). Prior to the introduction of the third-country passport, the placement is only admissible if the AIF-KVG and the management of the AIF correspond to the requirements laid down in the KAGB. The requirements on the depository, however, are different, as for the placement to professional investors, only one body must be designated which is independent of the AIF-KVG and takes on depository functions, whereas the placement to semi-professional investors requires a regulated depository pursuant to the KAGB (Sect. 329 para. 1 no. 1 and no. 1 KAGB).

Additionally, the requirements on third countries (with the exception of tax agreements) with regard to the AIF must be fulfilled. As of the coming into effect of the KAGB, the European placement passport will be available for the placement of EU-AIF by EU-AIF management companies (Sect. 323 KAGB). The placement then only requires a notification to the supervisory authority of the state of origin of the management company which within 20 days forwards to BaFin the AIFM confirmation and the AIF notification letter and which informs the management company about the forwarding of these documents. The placement can take place after the documents were submitted. Prior to the introduction of the third-country passport, the placement of foreign AIF by EU-AIF management companies is admissible under the same conditions as the placement by an AIF-KVG. A difference is that the EU-AIF management company must comply with the implementation act of the AIFM Directive. After introduction of the third-country passport, the notification about the placement intention will not be directed to BaFin anymore but to the supervisory authority of the state of origin of the EU-AIF management company (Sect. 324 para. 2 KAGB). The further procedure corresponds to the procedure associated with the European placement passport and, additionally, the requirements on third-countries for the AIF. Foreign AIF management companies may place EU-AIF to professional and semi-professional investors already prior to the introduction of the third-country passport.

It is required that the foreign AIF management company complies with certain information and disclosure obligations and designates a body independent of the AIF management company that takes on the depository function (Sect. 330 para. 1 no. 1 KAGB). If placement is intended also to semi-professional investors, the management company and the management of the AIF must completely comply with the AIFM Directive (Sect. 330 para. 1 no. 2 KAGB). Moreover, in both cases the requirements on third countries must be fulfilled (with the exception of the tax agreement). BaFin's evaluation period is between two and eight months (Sect. 330 para. 4 KAGB). After introduction of the third-country passport, the rules and regulations of the European placement passport will apply. The placement notification must be submitted to the competent supervisory authority

of the relevant reference member state (Sect.s 325 and 327 KAGB).

The above applies to the placement of foreign AIF by foreign AIF management companies (Sect.s 326 and 328 KAGB). However, it must be noted that the requirements on third countries must be fulfilled with regard not only to the management company but also to the foreign AIF.

Interim provisions

To allow sufficient time to the management companies to adapt their organization and the fund products they manage to the supervisory obligations of the KAGB, the KAGB provides for interim provisions applying to the management companies and the investment undertakings, and grants grandfathering to certain constellations. AIF-KVG that carried out activities of an AIF-KVG already before July 22, 2013, must apply for permission as AIF-KVG no later than July 21, 2014 or register as "small AIF-KVG" (Sect. 343 para. 1 KAGB). In a transition period lasting until January 21, 2015, however, they are permitted to launch new AIF prior to being granted approval (Sect. 343 para. 3 KAGB). Before submission of the permission application to BaFin, the AIF-KVG is subject to the Investment Act.

Immediately after receipt of the application, however, the obligations laid down in the KAGB and the EU Regulation must be completely complied with (Sect. 345 para. 2 KAGB). Particularly the KVG of closed AIF that were previously not regulated will face the challenge to reorganize their business operations in accordance with the new provisions of the KAGB until the submission of the permission application. The interim provisions of open AIF differentiate if the AIF was already regulated pursuant to the Investment Act (Sect. 345 KAGB) or not (Sect. 351 KAGB). The principle is that the investment conditions or the articles of association of the open AIF must be adapted to the KAGB no later than July 21, 2014 (Sect. 345 para.s 1 and 3 KAGB). Simple editorial changes of public AIF do not require approval of BaFin. The adaptation must be made at the time of the application for permission as AIF-KVG at the latest. Until the modified investment conditions come into force, the provisions of the Investment Act continue to apply for the AIF. The following applies to the placement of open AIF: Domestic public or special AIF launched already before July 22, 2013 can be further placed until July 21, 2014 at the latest or until the coming into effect of the adapted investment conditions pursuant to the provisions of the Investment Act (Sect. 345 para. 6 and 7 KAGB). Subsequently, a placement is only permitted following successful notification procedures in accordance with the KAGB. Pursuant to Sect. 139 Investment Act, AIF management companies can continue to place AIF which are eligible to placement until July 21, 2014. As of this point in time, a successful notification procedure is required for the further placement (Sect. 345 para. 8 KAGB).

The same applies to EU-AIF or foreign AIF that were previously placed privately (Sect. 345 para. 9 KAGB) and to EU-AIF or foreign AIF that were previously not to be qualified as investment undertakings in accordance with the Investment Act (Sect. 351 para. 5 KAGB). An AIF management company of closed AIF does not require approval und does not need to comply with the provisions of the KAGB as long as it exclusively manages closed funds which do not make any additional investments after July 21, 2013 (Sect. 353 para. 1 and 2 KAGB). "Making additional investments" means concluding a new agreement on an investment of capital to generate a profit, if the investment does not (i) result from an existing obligation, (ii) account for a minor share of the portfolio and (iii) exclusively serve the conservation of value. As soon as the activity of the management company is not exclusively limited to fully invested closed funds anymore, for instance because it also manages closed funds that make additional investments, a permission is required by July 21, 2014 ("risk of infection" – see Sect. 353 para. 7 in conjunction with Sect. 343 KAGB).

Extensive product regulations do not apply to an AIF-KVG managing closed domestic AIF which in fact make additional investments until July 21, 2013, but whose subscription period expired before July 22, 2013, so that the AIF-KVG can maintain the investment strategy of the AIF (Sect. 353 para. 4 KAGB). Apart from that, the provisions of the KAGB apply. With regard to closed AIF which were launched before July 22, 2013 but whose subscription period does not expire before July 22, 2013 and which still make investments after July 21, 2013,

the investment conditions and partnership agreements must be adapted to the KAGB by July 21, 2014 (Sect. 353 para. 6 in conjunction with Sect. 351 KAGB). Until this date, placements can be made in accordance with the previously applicable provisions (including private placements). Placements made after this date, however, require a notification procedure.

If you have any questions or require specific advice on any matter discussed in this publication, please contact one of the lawyers listed below:

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