Deloitte.

April 2016

Investment Management Newsletter 1/2016
Current Regulatory Developments

Credit Funds – Just another product alternative for Alternative Investment Funds?

A revision to the administrative practice of the BaFin, as well as the German Federal Parliament's final approved version of the legal draft for the implementation of the UCITS V directive, has enhanced the scope for setting up credit funds in Germany in the form of alternative investment funds (AIF). The additional options available to market participants – depending on their individual situation – should now be considered: The investment management companies (KVGs) have gained additional business potential through the use of credit funds, however they must guarantee a MaRisk (minimum requirements for risk management) conform credit choice and processing model. Banks now have the possibility to not only take risks onto their own books, but also to act as Agent for KVGs activities, which means selling their credit know how, without having to submit themselves to the necessary own capital requirements. Credit funds open alternative investment avenues to institutional investors and above all to insurers, pension schemes and pension funds.

The characteristic traits of fund types defined under the German term "Kreditfonds" or under the English terms such as credit funds, loan funds or debt funds are not yet clear-cut. The set-up of the funds can happen in very different ways, but includes a fundamental minimum investment of the funds in (un-) secured credits. Currently in addition to the laws and legal initiatives that exist on a European level (e.g. ELTIF, EuSEF, EuVECA regulations, or the planned ESMA discussion paper on "Loan originating AIFs"), there also exist the precursors to credit funds at the EU member state level (e.g. Ireland), which define the legal bases for loan acquisition, as well as for the original granting of loans for the account of investment funds. In principle, these funds can be sold to professional investors in Germany within the scope of the EU passport. According to recently made available information, the status in Luxemburg is that there is neither a specific legal basis nor any guideline from the Luxembourgish supervisory authority (CSSF). Therefore, existing funds restrict themselves to the secondary market acquisition of loans.

Legal framework for credit funds in Germany

In Germany, the launching of credit funds was allowed even before BaFin had revised its administrative practice or the draft of the UCITS V Implementation Act had been published. However, investment funds could only acquire loans up to 30% of the net asset value of the fund for the account of "special funds" until the KAGB came into force on 22nd July 2013, though only the acquisition of loans on the secondary market or using a fronting bank was permitted. It was BaFin's view that restructuring or prolongation of loans as well as the original granting of loans (loan origination) were considered to constitute the act of a credit transaction and were therefore illegal banking transactions for investment management companies according to § 1 para 1 No. 1 KWG (German Banking Act). For this reason, only a few credit funds have been issued up in Germany until now.

On May 12, 2015, BaFin issued a circular (WA 41-Wp2100 – 2015/001) in which it changed the previous practice under reference to a respective derogation rule in the KWG (§ 2 para 1 No. 3b KWG). According to the circular, investment management companies (KVGs) are allowed to grant loans, as long as they are part of the process of collective portfolio management. The derogation rule of the KWG was originally set up for the security deposit business which under German law is considered to be a banking business. When the investment act was established, no one considered the granting of loans as possibly being part of the collective portfolio management. However, the wording of the regulation and its interpretation based on new European laws (e.g. allowing loan origination in the EuVECA and EuSEF regulations), could also be referred to loan origination within the business of collective portfolio management. In the context of the German implementation act for the UCITS V Directive (the bill version passed by the Federal Parliament) the legal framework for investment opportunities of funds in loans will now be extended by respective changes in the KWG and KAGB (German Capital Investment Act). § 2 para. 1 No. 3b KWG is being changed insofar as the derogation regarding the collective portfolio management is explicitly extended to allow the origination of loans.

The BaFin circular already clearly stated that the credit business will (continue to) be a regulated business due to the necessity to protect the market. This means that investment management companies do not have to obey the solvency rules of banks. However, they must comply with the respective organisational and risk management rules as stipulated in the minimum requirements for risk management of banks ("MaRisk", BaFin circular 10/2012 (BA) dated 14th December 2012, which is currently under revision), as long as they refer to credit business (BTO 1 credit business and BTR 1 credit risks). In the KAGB, the new legal basis for special regulations for the operational and organisational structure of credit business was built by adding the new paragraph 5a to § 29 KAGB-E. There are exceptions for credits according to UBGG (German law for companies participating in non-listed companies), for loans made to real estate companies granted by open-end real estate funds or for shareholder loans e.g. in the private equity area. With this rule, special requirements for risk management will apply to nearly **all AIF** investment management companies (AIF-KVGs), which are going **to grant** future loans on account of the AIF **or invest** in non-securitised/certificated loans.

The AIF-KVGs will have to establish structures for loan processing (including loan extensions), loan processing controls and the handling of problem loans as well as procedures for early risk diagnosis, appropriate for the type and extent of their business. According to the UCITS V Implementation Act, the "one million euro credit report" as defined by §14 KWG shall also be filed by the AIF-KVGs.

Additional requirements arise for the actual **loan origination**. The scope of application for the origination of loans is restricted according to the German implementation act for the UCITS V Directive (adaption of § 20 para. 9 KAGB draft bill) as follows:

- Loan origination is excluded for the account of UCITS.
- Loan origination is allowed for AIFs, provided it is permissible in accordance with the European regulations governing the European Venture Capital Fund (EuVECA), European Social Entrepreneurship Fund (EuSEF), European Long-Term Investment Fund (ELTIF) or the AIF is a domestic closed-end Special-AIF which fulfills the requirements of the new para. 2 of § 285 KAGB draft bill (see below regarding closed end funds). Additionally shareholder loans according to § 285 para. 3 KAGB draft bill can be granted by closed-end or open-end Special-AIFs.
- Changes to the conditions of loan origination or acquisition (restructuring / prolongation) are excluded from the above-mentioned provisions and restrictions for loan origination, which means, they are permitted in general; meanwhile, this regulation also applies again to open-end Special-AIFs, after they were previously excluded from this possibility in the federal government draft law.
- External investment management companies (KVGs) may grant money loans to their parent, subsidiary or sister companies for their own account.

For **closed-end** Special-AIF which intend to allocate loans for the account of fund assets in the future, further framework requirements arise from the UCITS V Implementation Act from the amended paragraphs 2 and 3 of § 285 KAGB draft bill:

- Leverage restriction: § 285 para. 2 KAGB draft bill decrees that for closed-end Special-AIF loans only credits up to 30% of the aggregated invested capital and the committed, but uncalled capital may be taken out.
- No granting of loans to consumers in the sense of § 13 of the BGB (German Civil Code).
- Risk distribution / risk limitation: The AIF-KVG may only grant loans to a borrower to the maximum total amount of 20% of the aggregated invested capital and the committed, but uncalled capital of the closed-end Special-AIF.
- In contrast to the above-stated limits, according to § 285 para. 3 KAGB draft bill, loans in the amount of maximum 50% of the aggregated invested capital and the committed, but uncalled capital of the open-end or closed-end Special-AIF (§§ 282 para. 2 sentence 3, 284 para. 5 KAGB-E) or of maximum 30% of the aggregated invested capital and the committed, but uncalled capital of a closed-end mutual AIF (§ 261 para. 1 No 8 KAGB draft bill) may be granted to associated companies (shareholder loans), if they are classified as subordinated loans or if they do not exceed the acquisition value (mutual funds) or the double acquisition value (special funds) of the respective share. Alternatively, subordinated loans of more than 30% of the capital may be granted to associated companies, if they are subsidiaries of the Special-AIF and which themselves only grant money loans under the above-described circumstances.
- Annual report, management report, audit: According to the new § 48a KAGB draft bill, AIF-KVGs registered according to § 2 para. 4 KAGB which grant loans according to § 285 para. 2 KAGB draft bill have to prepare and provide for every closed-end domestic Special-AIF an annual report (including balance sheet oath according to § 45 para. 2 No. 3 KAGB) and a management report, have to certify them by an auditor and make them available to their investors upon request. For the financial accounting, the regulations for private limited investment part-

nerships (Investmentkommanditgesellschaften, InvKGen), especially § 135 para. 3 to 11 KAGB, apply accordingly. Further specifics regarding contents, extent and presentation of the report may be as well be decreed in the KAPrüfbV (the Investment Management Audit Report Ordinance). For the accounting and audit of other investment funds which are administrated by accredited investment management companies, specific regulations for the credit business may be added to the KARBV (the Investment Accounting and Valuation Ordinance) und die KAPrüfbV through already existing powers to issue delegated acts. The BaFin has also already proposed the inclusion of necessary changes to the respective rules in the ordinances in the context of the amendment to the KAGB act.

- Prevention of conflicts of interests: The codes of conduct in §§ 26 and 27 KAGB are supposed to avoid possible conflicts of interests which could arise with an origination of loans – additional legal regulations are not required.
- Organisation and Risk Management: In connection with liquidity risk management (§ 30 KAGB) no additional regulations are necessary. For the determination of the requirements for the organisational and risk management duties of KVGs for the granting of cash loans or for investing in unsecured loans, the new § 29 para. 5a KAGB draft bill was created. This should serve as the basis to explain the applicability and use by the BaFin of the relevant rules that are applicable to banks under the MaRisk. For the applicability of the rules in total, some exceptions were allowed, for example for loan investments by closed-end mutual AIF or for loans granted to real estate companies for the account of the real estate fund according to § 240 KAGB. Registered KVGs, that have granted loans for the account of investment funds, have the legal obligation to observe the organisation and risk and liquidity management rules.

The following overview shows the investment possibilities of the individual fund types in loans:

Fund Type	KAGB-E	Investment in Loans	Loan Granting/ Lending	Loan Structuring	Shareholder Loan
UCITS	§ 192	no	no	no	no
Open-end domestic mutual AIFs ("other investment fund")	§ 221	yes	no	yes	no
Real estate special estate AIFs (granting loan to its real estate company)	§ 240	no	no	no	yes, as before
Closed-end domestic mutual AIFs	§ 261	no	no	yes	yes (conditional)
General open-end Special-AIFs	§ 282	yes (up to 100%)	no	yes	yes (conditional)
Open-end domestic Special-AIFs with fixed investment conditions	§ 284	yes (up to 100%)	no	yes	yes (conditional)
Closed-end Special-AIFs	§ 285	yes (up to 100%)	yes, under conditions (foreign financing up to 30%, no loan to consumers, max. 20% to each loan taker)	yes	yes (conditional)

In summary, the Legislator believes that, on the basis of European legislation and also on the basis of market practice in other European countries, with this construction, a further option for the funding of the real economy is being created. At the same time, the legislator wants to prevent the transfer of risky loan transactions to a less-regulated market area (shadow banks), also by e.g. implementing the requirements for the credit processes.

Consequences for market players

The new business area of allocating loans on account of an AIF can have different consequences for the market players (banks, asset managers, institutional investors and where applicable service providers) and provides them with different options.

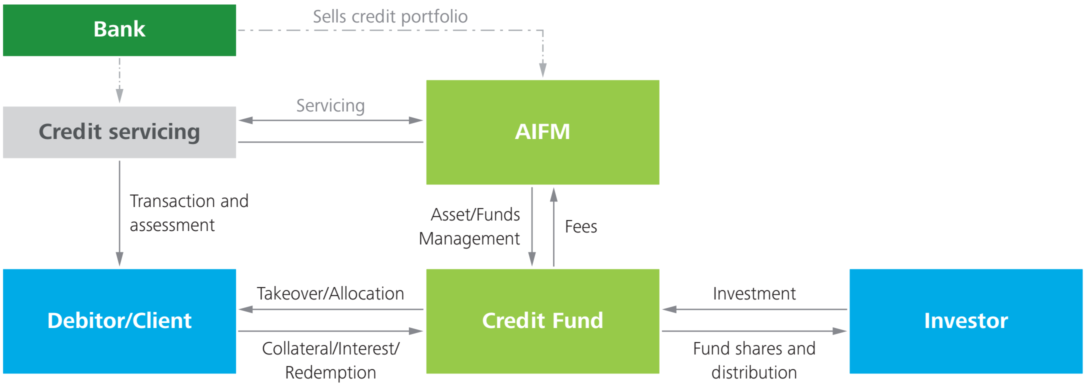
An institutional investor can have appropriate chances to make profits (while at the same time accepting the risks), but they should be above the market level to actually be of interest for the investor. For insurance companies and pension pools, the VAG (German Insurance Supervision Act) in connection with the investment ordinance or the new supervisory body of rules and regulations for insurance companies Solvency II determines the "regulatory" leeway which these companies will have when investing in credit funds.

The issuing AIF-KVG has to appropriately organise their new business area "credit". For this, expertise within the portfolio and risk management has to be acquired regarding asset selection, diversification, asset assessment and so on. With the credit processing the AIFM has to comply with the MaRisk (Minimum Requirements for Risk Management), especially parts BTO 1 (credit business) and BTR 1 (credit risk), as well as set up the necessary. To comply with this regulation the KVG needs to establish an operating model for the credit business. So the KVG has to weigh up the revenue prospects of the additional funds business against the mandatory investments for complying with the credit management regulations.

Instead of establishing the organisational framework and processes on its own, the KVG has the alternative to source out the credit business to a respective service provider. Here it will be of importance, whether the service provider has enough incentives to insource the credit funds processes (e.g. review business models, margins). In this scenario, the asset manager can generate additional funds business and at the same time get the credit business operating in a cost-saving and more efficient way through a specialised provider. However, it has to be ensured that the KVG has to build up a certain compentency level to comply with the existing requirements of the outsourcing controlling.

To develop the thought of the outsourcing of the credit processes there eventually arise new opportunities for financial institutions and especially for those with asset management subsidiaries. On the one hand financial institutions could sell credit portfolios to a KVG or could place debtors with the KVG with whom they could arrange - considering possible conflicts of interest - to take over the credit processing. The KVG (subsidiary of a bank) finds one or more investors for the credit portfolio and issues the fund in accordance with their specifications. The advantage for the financial institution is that the risks of the credit business could be transferred and therefore a more efficient management of the own funds and the relevant indicators according to CRD IV is possible. Apart from this the arrangement it allows the financial institution to maintain the relationship with the client/debtor, because the credit processing functions are still within the bank. Thereby an increase and diversification of the credit business is possible without strains of the own funds requirements and is independent of the bank's readiness to assume risks, offering a broader range of products and solutions with additional earnings from the Servicing (commission earning) instead of interest earnings.

The following picture gives a schematic overview of the possible relationships between the market participants:



To what extent credit funds establish themselves on the market (also in relation to already introduced products) depends on the following parameters:

- The final legal framework in Germany has to be designed in a way, that there are incentives for all involved parties to invest in the product and that there are no competitive disadvantages in comparison to the settings in other European member states.
- Expertise of the fund management regarding the selection, the structuring and the management of the investments (by means of outsourcing controlling where necessary)
- Opportunity for the KVG to get access to senior debt portfolios with good rates of return to risk ratios, in which institutional investors are interested the most. In this context a cooperation with financial institutions can be reasonable. However, possible conflicts of interest deriving from the cooperation with the bank have to be considered.
- Distribution of the incentives/revenues between the involved parties: the financial institution as the originator of the debt claim, the asset manager and the investors as well as the service provider, where applicable.
- Eventually the supervisory authorities will have an interest in preventing an increase in credit fund scenarios, which allow the transfer of credit risks in unsupervised market areas. It´s expected that in Europe, frameworks for credit funds will be established to prevent systemic risks without a significant limitation of the possibilities for company and infrastructure financing. One has to wait which effects possible compromises of the regulation authorities may have. First thoughts in this context can be found in the ESMA report on Trends, Risks and vulnerablities 1/2015 and the ESRB (European Systemic Risk Board) paper on "Loan Origination by Investment funds". Here it remains to be seen, what effects and possible regulation compromises it will have on the development of funds that grant loans.

Outlook

The market success of credit funds will depend on the regulatory constraints that lie ahead in the standardisation in the KAGB and of the implementation in European law. On the market side the credit funds will be fighting against the already established and the, once again classified as eligible, securitisation market (STS certificate, true sale securitisation). In relation to other (securitisation) fund types, an AIF credit fund within the meaning of the German regulation will have some additional features. It remains to be seen, how the market participants will use the leeway offered and how the German framework will work in comparison to the credit fund alternatives of other European member states.

Subtraction method – Determination of the own fund requirements pursuant to Section 25(4) German Investment Code

Capital requirements for capital management companies (CMCs)

Capital management companies which manage German investment funds, EU investment funds or foreign AIFs are required to comply with certain own fund requirements pursuant to Section 25 of the Investment Code. In respect thereof, external CMCs must have an initial capital amounting to at least kEUR 300, and internal CMCs must have an initial capital of at least kEUR 125. Furthermore, AIF capital management companies and external UCIT capital management companies must have at their disposal additional own funds in an amount of at least 0.02% of the amount by which the value of the assets under management exceed mEUR 250, although the own fund requirement, understood as the initial capital plus the additional own funds, is capped at mEUR 10. However, the requirements of additional own funds may be reduced by up to 50%, provided guarantees from certain credit institutions are furnished in the corresponding amount. Where the management of investment funds has been outsourced to third parties, these funds will be included in the calculation of the additional own funds, while investment funds which are managed by the external CMC on behalf of third parties will not be included in the calculation.

In addition, Section 25(4) of the Investment Code lays down special own fund requirements. Pursuant thereto, capital management companies must hold own funds in an amount of one-quarter of their fixed costs based on the previous year at all times, regardless of the aforementioned requirements. The amount of own funds required is therefore the higher amount pursuant to paragraph 1 (initial capital and additional own funds) and paragraph 4 of the Investment Code. New regulations have caused the authorities to change their practice in respect of the determination of the own funds and the expenses to be covered; this will be presented below.

Subtraction method replaces the addition method

The previous administrative practice had required that the operational risks be covered by own funds in an amount of at least 25% of the general administrative costs, as well as amortisation/depreciation and adjustments for intangible and fixed assets. In the framework of this so-called "addition method", specific profit and loss account line items were used to determine the expense items to be covered, the balances of which were to be added.

In the German Federal Financial Supervisory Authority's (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin) opinion, the application of the addition method has no longer been in compliance with EU law since the Capital Requirements Directive IV took effect, although the wording of the Investment Code, which remains valid until 18 March 2016, calls for the addition method. Although the AIFM Directive and the UCITS Directive, the implementation of which resulted in Section 25(4) of the Investment Code, refer to the old Capital Requirements Directive, this cannot be understood in BaFin's view as a static reference because of Art. 163(2) of Directive 2013/36/EU (Capital Requirements Directive IV), which states that references to the repealed Directive are deemed to be references to the new Directive or the Capital Requirements Regulation (CRR), meaning that the calculation of own funds must now be carried out on the altered basis of the Capital Requirements Directive IV.

The so-called subtraction method, which is currently applicable, is defined in Art. 97(1) of the CRR. Details are described in a delegated regulation that is based on a proposal by the European Banking Authority (EBA) on "own funds requirements for investment firms based on fixed overheads under Article 97 (4) of regulation No 575/2013".

Pursuant to the accordingly amended Delegated Regulation 2015/488, which contains the interpretation of the above-mentioned Article, the institutions concerned (and therefore also capital management companies) are required to calculate the assessment base for the own funds requirements on the basis of the full overhead costs incurred in the previous year by initially adding any and all items of the profit and loss statement pursuant to the national accounting standards (here the German Commercial Code [Handelsgesetzbuch, HGB] in consideration of to the provisions of the German Regulation on the Accounting Requirements for Banks [Verordnung über die Rechnungslegung der Kreditinstitute und Finanzdienstleistungsinstitute, RechKredV]) as "total expenses". However, certain line item expenses may then be deducted (subtracted), provided these are of a variable character in the opinion of the legislator or are related to entries without which they would not arise.

The date on which the new, amended requirements become applicable is still controversial. Section 25(4) of the Investment Code will be amended to bring it into line with the subtraction method within the framework of the

German UCIT Directive Implementing Act (OGAW Verordnung Umsetzungsgesetz, OGAW V-UmsG). However, in the view of the legislator, it was plain from the justification that the amendment was only a clarification, since the wording up to that point did not comply with European law and the corresponding provisions in the Investment Code were therefore to be interpreted accordingly before the amendment. BaFin also shares this view. The German Investment Funds Association (Deutsche Fondsverband, BVI), however – also owing to the questions which still remain open – has not communicated this interpretation to its members in this way, so that the majority of the members continue to rely on the previous wording of Section 25(4) of the Investment Code until the amended version takes effect and continue to calculate their own funds requirements in accordance with the addition method unless BaFin expressly directs that the CMC perform the calculation pursuant to the new provisions in an individual case.

New requirement for the calculation of the own funds ratio

The requirements for the calculation of the own funds ratio for financial service institutions were more precisely in a circular letter. At the same time, BaFin also published a reporting form for financial service providers which, although not directly applicable to capital management companies, can nonetheless be applied to determine the own funds requirements.

a) Requirements for own funds

Pursuant to a reference in Section 1(19) no. 9 of the Investment Code, Art. 72 of the CRR is binding for the determination of own funds requirements. The aforementioned Article branches off into all provisions in the CRR, i.e. Regulation (EU) 575/2013, concerning own funds.

The CRR and the Delegated Regulation (EU) No. 2015/488 contain controversial requirements in respect of the attribution of own funds components which are subject to profit-and-loss transfer agreements. In the EBA's view (Single Rulebook Q&A, Question ID 2013_408), own funds components subject to such an agreement will not be recognised as (common) equity because they are not suitable for generating reserves. This justification is not reasonable because other – nonetheless recognised – components of common equity, such as capital reserves, are also not suitable for generating (additional) reserves, nor is this a legally required condition for the recognition of own funds.

Although BaFin has not made any official statements on the matter, based on the discussions of several banking associations with BaFin it appears that BaFin has preliminarily not adopted the EBA's view as its own, and correctly so.

In addition to this problem, it must also be borne in mind when determining own funds that certain items must be deducted from the underlying equity, including intangible assets.

The previous rule pursuant to Section 10(2a) sentence 2 nos. 4 and 5 of the German Banking Act (Kreditwesengesetz, KWG), old version, has been replaced by Art. 28(1)(b) CRR in conjunction with Art. 8 no. 3 of Delegated Regulation 241/2014. Pursuant thereto, loans to natural or legal persons who either hold a qualified participation in the institution or are deemed to be related parties within the meaning of IFRS 24(9) are to be deducted from own funds unless the institution can prove inter alia that the transaction was made at arm's length. As a result, the scope of application was significantly expanded in comparison to the previous legal situation. BaFin is of the view that the term "loan" must be defined in accordance with provisions concerning the term "borrowing" set out in Section 19 of the Banking Act, pursuant to which assets, derivatives and other off-balance sheet items are to be attributed to borrowings. Cash pools or unsecured and/or non-interest bearing receivables, among other items, are not to be regarded as being in line with the market if interest or collateral is otherwise ordinarily required on the interbank market for comparable receivables. Intragroup receivables due on demand which are held as a part of the required liquid investment of own funds pursuant to Section 25(7) of the Investment Code, for example, might also therefore be regarded to be items which must be deducted under the aspect of the arm's-length principle.

b) Deduction items

Not only is the determination of own funds, but also the determination of the costs for the capital is decisive. In the framework of the subtraction procedure, all expenses are initially added up without restriction. Then bonuses and profit participations for the staff, executive-level employees and managers can be deducted, as well as other expenditures, provided these are "fully discretionary". The term "fully discretionary" is to be understood as meaning an expenditure which is entirely within the company's discretion and for which there is no contractual claim to payment.

Pursuant to the currently applicable CRR, there is also a capital adequacy requirement for expenditures resulting from profit-and-loss agreements because the company is not able to avoid the obligation to pay out dividends, whereby these are, in principle, not variable. In BaFin's current view, these expenditures may nonetheless provisionally be deducted in the framework of the subtraction procedure.

In addition, the deduction of expenses for commissions which are directly related to commission revenues is possible under certain circumstances, although the interpretation here often depends on the circumstances of the individual case. BaFin has confirmed that expenditures which are passed on to sales partners and which are treated as part of the management fees collected are deductible. Other expenses for commissions which depend on the net value of the portfolio under management are also deductible, provided these correspond to commission revenues and that these are also dependent on the net value of the portfolio under management. According to the provisional interpretation, this does not, however, apply to performance-based management fees, unless the corresponding expenditures have the identical basis for calculation, or to expenditures which are not dependent on the net value of the portfolio, such as base fees. In this connection, the deductibility of expenditures for outsourced portfolio management was controversial. Since then, however, it appears that, according to BaFin's provisional view, this is just as permissible as the deductibility of corresponding expenses for investment advice which is dependent on the net value of the portfolio.

Conclusion and outlook

The method for determining the own fund requirements within the meaning of Section 25(4) of the Investment Code has changed due to new regulatory requirements. Presumably, the new requirements are already applicable. The application of the subtraction method leaves several questions open in connection with the determination of the amount of own funds which are required, as well as the expense items which are to be covered. BaFin has already published a reporting form for financial service providers which can also be used by capital management companies as an aid in determining their own funds ratio. However, in respect of the recognition of the relevant items, it is necessary to monitor all the opinions and statements of all relevant authorities and to closely examine each case, as some of BaFin's proclamations are only provisionally applicable. This also applies in particular in those instances where BaFin's views conflict with the EBA's view. Hopefully, the EBA will also come around to an interpretation of the provision's wording which is closer to its object and purpose.

The Investment Management Compliance Framework

The Investment Management Compliance Framework in an overview, as seen from the perspective of Deloitte Financial Services IM

Investment Management Companies often feel challenged by the term Compliance.

In this article, we aim to promote an understanding of the importance and relevance of the Compliance function for investment management companies in general. We have also taken into consideration, some of the additional Compliance obligations resulting from the special developments of the German market.

The management boards of many investment management companies often only regard the Compliance function as a regulatory obligation and therefore a necessary, but non-productive expense. We believe that with the right approach, **a properly implemented Compliance organisation can bring a real benefit to the business and prevent it from incurring unnecessary fines and penalties**.

Inefficient Compliance organisations that either do not have access to all of the information they require to perform their function effectively, or do not establish effective controls across the whole company, are often unable to prevent excessive risks from being taken. This can result in severe consequences and reputation damage to the company. Recent prominent examples of Compliance organisations that have not operated effectively in the performance of their duties and which have led to reputation damage and huge fines for the companies concerned; can be seen in both the VW emissions scandal and the Deutsche Bank, Forex & Libor manipulations.

Therefore, we should not hesitate to reiterate the statement: **"The importance of the Compliance Framework and its added value to the business should not be underestimated."**

Accordingly, we would like to focus on the benefits the Compliance function can bring to the company, as well as its importance in assisting the management board to find the most successful way to develop the business, within the boundaries set by the plethora of ever-changing regulatory guidelines.

Therefore, we believe it is first necessary to remind the management board that the ultimate responsibility for the Compliance organisation rests with them.

Under European regulations and specifically in Germany, according to the Securities Trading Act (WpHG) and the Kapitalanlagegesetzbuch (KAGB), the regulator (BaFin) has laid down a set of minimum requirements (including those set out in the MaRisk, InvMaRisk, MaComp) that it expects to be set up in the Compliance function, by all financial institutions and investment management companies.

According to these requirements, management boards have the obligation to establish adequate policies & procedures and keep available resources (Financial, Human and IT) to ensure that the company itself, as well as its employees, comply with all of the relevant regulatory requirements that are applicable to the company's business.

In particular, this responsibility requires the establishment of a permanent and effective Compliance function, which is able to support not only the existing business processes, but also those required for business development, while at the same time acting to control and prevent excessive risks, as required.

To be able to perform properly, the Compliance function must have access to all the information it requires to be able to ensure effective performance of the established controls within the company. It must also be able to discharge its responsibilities independently.

The Compliance function must ensure that the Compliance Framework is properly established within the organisation to enable the Compliance team to perform its function as a "second line of defence" validating the policies, procedures and controls put in place by the operative business units "the first line of defence" and ensuring the effective performance of the necessary control activities. In fact, the operating business units are responsible for complying with the provisions of the law and for performance of the necessary required controls (internal controls).

The Compliance Framework must therefore be properly set up initially, to enable the Compliance function to act in the most effective manner. The Compliance function must ensure the operating business units comply with their day-to-day, as well as any future legal obligations and that they put in place sufficient and adequate controls to validate such compliance on an ongoing basis.

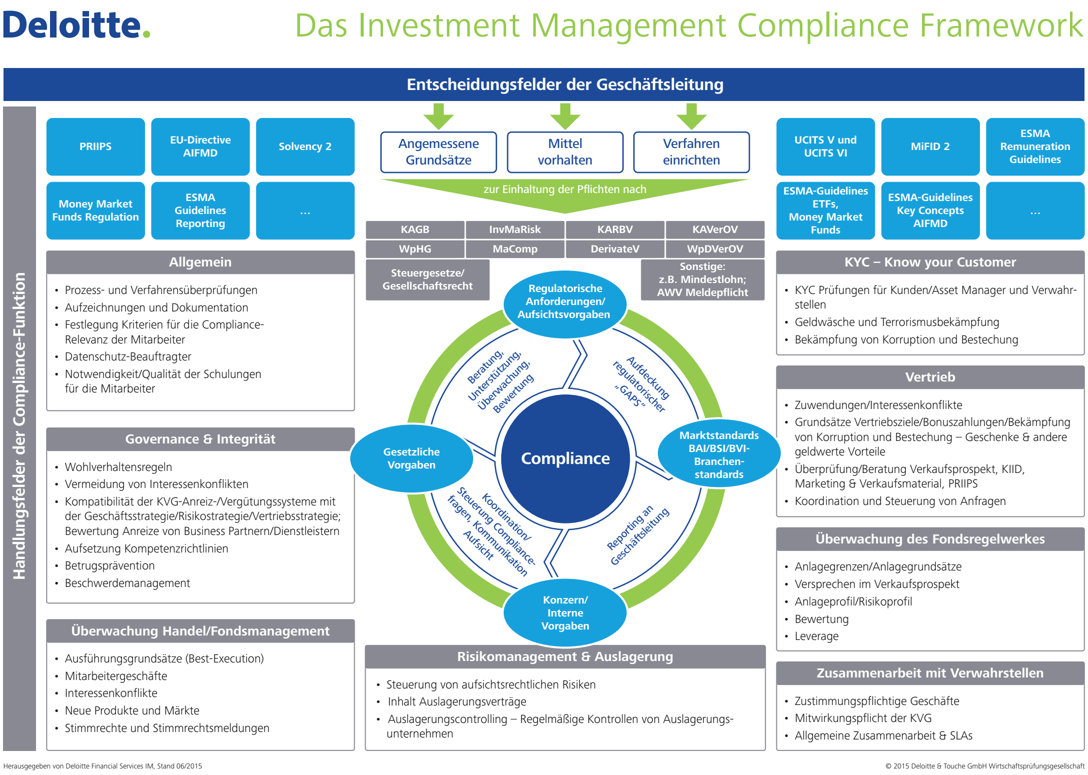
This requires an initial investment by the organisation in the Compliance function, both in terms of time and resources (human, IT and monetary), in order to build an adequately qualified Compliance team and a Compliance monitoring organisation, including controls and systems for monitoring and advising on the adaptation of policies and procedures as required.

The initial investment in the Compliance function can be significant, as it involves a lot more effort in the first year, due to the requirement to set up all of the necessary controls, as well as the monitoring organisation. However, thereafter efforts and associated costs should reduce dramatically as once all of the initial controls are in place, the Compliance function should become more involved in a control monitoring and advisory role for existing and future business, unless there are fundamental changes required to any critical processes.

Accordingly, the Compliance function should first perform an annual Compliance risk assessment on the activities of the entire organisation and from this determine both the necessary actions to take and/or projects to implement, with timelines to ensure Compliance. This can then form the basis of the Compliance audit plan for the year, enabling the Compliance function to check and see if all of the controls put in place are functioning in the way they should, or if any corrective, remedial action is necessary.

In addition, the investment management company must ensure that the overall internal control system of the organisation is functioning properly – Therefore at least on a random sample basis – control-monitoring activities should be performed and if not by compliance, by operational risk and /or internal audit, such as monitoring of trading by the back office and/other designated employees.

If properly implemented the Compliance Framework should cover all of the items shown in Deloitte's Compliance Framework (Including the obligation to cooperate with Custodians in Germany).



Currently for all Investment Management Companies, the regulatory focus on Compliance is rapidly gaining in importance.

With a vast number of new regulatory requirements being pushed through the European Parliament (CRD IV, CRR, MAD/MAR, MiFID II / MIFIR, EMIR, UCITS V (OGAW V), CSDR etc.) at the same time, along with the proposals, recommendations and standards coming from the Basel committee, IASB and IOSCO (e.g. BCBS 239, FINREP, IFRS 9 etc.). There is an ever-greater need to, not only, implement these requirements, but also, to ensure that a proper monitoring system is enabled through the Compliance function.

The consequence of not performing Compliance in a proper manner can result severe reputation damage for the company, as well as in severe penalties and sanctions from the regulators.

In our previously mentioned examples, VW and Deutsche Bank, both organisations had to make accounting provisions for billions of Euros in expected fines due to non-compliance with the rules.

Furthermore, in the worst-case scenario, Compliance failures can lead to personally damaging effects for the members of the management board. For example loss of the licence for the responsible member of the management board permitting them to operate the business, with its subsequent automatic personal reputation loss and/or even the loss of their jobs (which happened to both the CEOs of VW and Deutsche Bank).

It is therefore imperative for Compliance to find the right balance between monitoring of the day-to-day operations, ensuring conformity with the already existing regulations and informing management and the departments on how to adapt their procedures/processes for the future requirements.

The Compliance function also plays an increasingly important role in:

- development of new products,
- as an escalation point for complaints,
- development of the company remuneration scheme, to ensure no conflicts of interest exist, and
- advising on how to incorporate the new regulatory requirements into necessary project implementation and/or into the day to day operations, together the with the help of the Finance and Risk departments.

Compliance must not only ensure that the regulatory requirements are met, but they must also regularly report on the compliance and operational risks, as well as on any breakdowns in procedures, complaints and on regulatory changes to the Senior Management, advising them on the necessary next steps to be taken.

Compliance should also serve as the main point of contact with the regulatory supervisors for all matters concerning Compliance with regulatory and legal obligations by the Investment Management Company. In addition and in fulfilment of their independence function, they should also act as an early warning station alerting the regulators to any significant Compliance issues that may at the company in order to try to prevent any reputation damage to the company.

Conclusion

If the Compliance function operates as it is supposed to, then through the proper application of an annual Compliance risk assessment programme across the whole organisation, potential Compliance problem areas can be detected before they can become issues. Thus, the Compliance function serves as the right hand of the management board, providing them with timely warnings of the risk bearing capacity of the company, areas where the company requires improvement of its Compliance, as well as the risks arising from customer or product over-concentration, or the disappearance of target markets etc.

An efficient Compliance Framework ensures the proper control and monitoring, observance of/following of all rules associated with running the existing business, as well as ensuring that new business is developed to its optimum capacity, by ensuring timely requests and set up of all necessary licences, reporting and procedures that may need putting in place.

Such information should also enable the management board to allow them to proactively develop and adapt their business strategy as required.

An effective Compliance function is therefore imperative for ensuring not only a successful continuation of the existing business, but also for enabling a successful future business development.

German Investment Tax Reform Act (Investmentsteuerreformgesetz, InvStRefG)

By way of the following presentation, we would like to first explain the changes in the government draft of the Investment Reform Act (InvStRefG-RegE) vis-à-vis the draft for discussion. Subsequently, we will present the essential key points of future taxation of investments, followed by a more extensive presentation of the reform.

First, however, we would like to mention the following points which are of particular practical relevance:

- The InvStRefG-RegE does not call for any amendments to the German Corporate Income Tax Act (Körperschaftsteuergesetz, KStG), meaning that the tax exemption for profits from sales of free float shareholdings has been retained.
- As already contemplated in the ministerial draft, the InvStRefG-RegE contains a provision concerning so-called cum-cum transactions, pursuant to which the taxable party must be both the owner under civil law and the economic beneficiary for 45 days within a period of 45 days prior to and 45 days after the capital yield has become due and payable. Otherwise, withheld withholding taxes may not be credited or, where taxes on capital gains which were not withheld, these must be paid. The new provision is applicable to both direct investments and investments via an investment fund.
- In respect of the scope of application of the Investment Tax Reform Act in the version of the German AIFM Tax Act (AIFM-Steueranpassungsgesetz, AIFM-StAnpG), the transition period for grandfathered investment funds will be extended until the new tax system enters into force, as provided for in the ministerial draft.
- The requirement resulting from the judgment of the German Federal Fiscal Court (Bundesfinanzhof, BFH) of 17 November 2015 (VIII R 27/12), published on 10 February 2016, that investors subject to taxation in Germany who invest in non-transparent investment funds established in a third country may avoid the flat-rate tax, if they furnish proof of the correct tax base themselves, was not implemented in the InvStRefG-RegE.

A. Government draft bill: What is new in comparison to the ministerial draft?

The changes in the InvStRefG-RegE in comparison to the ministerial draft are far more moderate than was the case in the transition from the draft for the discussion to the ministerial draft. As expected, linguistic adjustments and editorial changes were made, individual paragraphs were restructured and split up, and new terminology was introduced.

In respect of substantive changes, we would like to highlight the following changes in particular:

- When determining the investment fund's income which is not subject to withholding tax, income-related expenses, which are only indirectly economically related to the income, may also be deducted.
- The deadline for the submission of the status certificate or proof of eligibility for a tax exemption on the basis that the investors are tax exempt will be extended to 18 months.
- The group of investors for whom domestic income from real estate may be treated as being tax exempt will be expanded to include legal entities under public law (in particular pension funds). The same applies to German companies, partnerships or estates which are exempt from corporate income tax and comparable foreign companies, partnerships or estates which have their registered office and headquarters in a third country which provides administrative and collection assistance.
- For non-profit, charitable or religious investors, tax-exempt status is to be proven by submitting a certificate issued by the investor's depositary in accordance with the official specimen after the calendar year has ended. The certificate must contain information on the number of the investment fund units held continuously throughout the calendar year, as well as on the date and number of the investment fund units acquired or sold in the course of the calendar year (investment fund unit portfolio certificate).
- The group of investors which falls within the scope of application of the tax exemption for domestic income from real estate in the case of investment funds or share classes with tax-favoured investors will be expanded in accordance with amendments to Section 8(2) InvStRefG-RegE.
- Legal consequences for the repeal of the investor's tax-exempt status will be established. In this respect, the investor will be obliged to notify the investment fund.
- The depositary will be liable without the possibility of exculpation for the taxes which were incorrectly reimbursed or not collected on the basis of a false investment fund unit portfolio certificate.

- In respect of the trade-tax exemption, only active entrepreneurial management harmful to a significant extent. In respect of the 5% threshold, the term "commercial" has been replaced by the term "active entrepreneurial management".
- The advance lump-sum amount is not to be recognised for health or nursing care insurers if the units in the investment fund are held for the purpose of securing old-age provisions.
- When determining the advance lump-sum amount, it is not the advance lump-sum amount which is limited, but rather the base amount on the additional yield between the first and the last redemption price.
- The cut-off date for the grandfathering period for special investment fund units held by a natural person via a partnership was changed from 1 May 2015 to the date on which the German Federal Government adopted the resolution (24 February 2016).
- The possibility of investing special investment funds in investment funds was restricted. All of the conditions applicable to the special investment fund must now be fulfilled, with the exception of investment supervision, the special right of termination and the formal requirement that the rules governing investments be set out in the terms and conditions of investment.
- For the purpose of applying the partial exemption rule or the investor privilege rule (Beteiligungsprivileg), there is a look-through of the special investment fund to prevent abusive tax structures for credit institutions, financial service providers and financial enterprises.
- The special investment fund's legal representative's liability is limited to wilful conduct when the transparency option is exercised.
- In respect of the tax-exempt capital gains which can be retained, only the proceeds from swap agreements are exempt and not the derivatives in sum total where the amount of the swapped capital flows is based on interest or dividends.

B. Key point of the taxation of investments in the future

The InvStRefG-RegE sets out a fundamentally new regime for the taxation of income which is generated from an investment fund. Whereas the transparency principle is to be replaced by a non-transparent tax regime for retail investment funds (which are only called "investment funds" in the future), the existing system of taxation is slated to continue to apply in a modified form to special investment funds.

Scope of application

The scope of application will be significantly expanded in comparison to the current German Investment Tax Act (Investmentsteuergesetz, InvStG). In future, all investment funds within the meaning of the German Investment Code (Kapitalanlagegesetzbuch, KAGB), i.e. Undertakings for Collective Investments in Transferable Securities (UCITS) and Alternative Investment Funds (AIFs), will be subject to the Investment Tax Act. Most of the exceptions under the Investment Code will be taken into account (e.g. holding companies and securitisation vehicles). Furthermore, the Investment Tax Act will in future recognise notional investment funds (fiktive Investmentfonds) which will also fall within the scope of applicability. On the other hand, the scope of application is not intended to extend to investment funds having the legal form of a partnership, except for UCITS or pension funds. Contractual investment schemes (Sondervermögen) and comparable foreign legal forms have not been deemed to be partnerships in this respect.

Investment funds

The core of the reform is the renunciation of the principle of tax transparency for investment funds. Whereas previously the investor in an investment fund was generally taxed as if he or she were a direct investor in the underlying assets, directly and without the interposition of the investment fund, the reform plans contemplate taxing him or her in accordance with the separation principle (Trennungsprinzip) in the future. Accordingly, German and foreign investors are partially (i.e. in respect of certain income) subject to corporate income tax, whereby a tax exemption can be granted only when certain investors participate.

Furthermore, the taxation at the investor's level is structured such that distributions, an advance lump-sum amount and profits and losses from the sale of units in the investment fund are taxable. A partial tax exemption may be applicable to certain investment funds in all three cases.

Special investment funds
Pursuant to the InvStRefG-RegE, a special investment fund is an investment fund which fulfils the conditions for an exemption from trade tax. Accordingly, the objective purpose must be restricted to the investment and management of the funds for the joint account of the unit holders, and the assets may not be actively entrepreneurially managed to a significant extent. In the case of participation in real estate companies within the meaning of the Investment Code, on the other hand, active entrepreneurial management is permissible. Furthermore, the special investment fund may not materially violate additional conditions, which essentially correspond to the current catalogue of conditions set out in Section 1(1b) sentence 2 of the Investment Tax Act. In derogation to the currently applicable law, natural persons may no longer participate indirectly via a partnership, and their participation is otherwise only permitted pursuant to a limited number of exceptions.

Generally, special investment funds are also subject to partial corporate income tax, which, however, can be avoided where the so-called transparency option is exercised.

As before, the investors tax the distributed dividends, distributions equivalent to dividends and profits or losses generated from the sale of units in the investment funds according to the law to which they are subject.

Transitional provisions
The new tax system is intended to be applicable from 1 January 2018, irrespective of what the investment fund's financial year might be.

Units in investment funds, capital management enterprises in the sense of the Investment Tax Act or investment vehicles which fall within the scope of the new Investment Tax Act for the first time on 1 January 2018 will be deemed to have been sold upon the end of 31 December 2017 and will be deemed to have been acquired upon the start of 1 January 2018. The profits or losses will not be recognised until the time that they are actually sold.

Units in investments which were acquired prior to 1 January 2009 (i.e. prior to the introduction of the withholding tax [Abgeltungssteuer]), and which have continuously been held as non-business assets since their acquisition, shall be tax exempt in respect of any increase in value realised in the period between the time of their acquisition and 31 December 2017. Any increase in value realised from 1 January 2018, on the other hand, are subject to taxation if the capital gains resulting from the sale exceed the tax-exempt amount of kEUR 100.

C. The future taxation of investments in detail

I. Essential aspects of the proposed reform
Der InvStRefG-RegE sieht für Investmentfonds einerseits und Spezial-Investmentfonds andererseits grundlegend unterschiedliche Besteuerungssystematiken vor. Im Zuge dessen wird auch der Anwendungsbereich jeweils neu definiert und die mit dem AIFM-Steueranpassungsgesetz eingeführte Abgrenzung zwischen Investmentfonds und Investitionsgesellschaften aufgehoben. Darüber hinaus sieht der InvStRefG-RegE eine weitestgehende Gleichbehandlung deutscher und ausländischer Investmentfonds vor.

1. Investment funds
a. Scope of application
First, any investment vehicle which fulfils the requirements for an investment fund within the meaning of the Investment Code (i.e. UCITS and AIFs) will qualify as an investment fund. Furthermore, the scope of application will be extended to so-called "notional" investment funds. Accordingly,

- undertakings for joint investments, whose potential number of investors is limited to a single investor, provided the remaining requirements applicable to investment funds are fulfilled,
- corporations which are prohibited from carrying out operating entrepreneurial activities under the law of the country in which they are established and which are not subject to any income tax or are exempted from such income tax, and

- corporate own investment funds within the meaning of Section 2(3) of the Investment Code (so-called "in-house investment funds")

are also considered to be investment funds.

The following, however, will not be regarded as investment funds:

- Investment vehicles to which an exemption pursuant to Section 2(1) and (2) of the Investment Code applies (e.g. holding companies and securitisation vehicles)
- Investment funds organised as a partnership or having a comparable legal form under the law of a third country, unless they are a UCIT or pension fund (contractual investment schemes and comparable legal entities under the law of a third country will not be regarded as a partnership for this purpose)
- Holding companies within the meaning of Section 1a(1) of the German Holding Companies Act (Gesetz über Unternehmensbeteiligungsgesellschaften, UBGG)
- Capital investment companies which acquire participations with own funds or state aid for the public interest
- Listed REITs pursuant to Section 1(1) of the German REIT Act (REIT-Gesetz, REITG) and other REIT entities, partnerships or estates (Vermögensmasse)

Furthermore, the justification for the act clarifies that neither asset management mandates nor certificates are subject to the Investment Tax Act.

As is the case in the current legal situation, determining the scope of application will be difficult in many cases because numerous interpretative questions arise concerning the abstract term "investment fund". Furthermore, it can be expected that there will be difficulties in determining when the German Foreign Tax Relations Act (Außensteuergesetz, AStG) applies instead, although the expansion of the scope of the term "investment" will lead to significantly more foreign companies being subject to German investment tax law than was previously the case.

b. Taxation of the investment fund
In future, the following income generated by an investment fund will be subject to German corporate tax:

- Domestic investment income (i.e. in particular dividends of German stock corporations and compensation payments from securities loan transactions)
- Domestic real estate income. This concerns domestic rental income and profits from the sale of real property located in Germany
- Other domestic income. This covers income pursuant to Section 49(1) of the German Income Tax Act (Einkommensteuergesetz, EStG), i.e. income for which a non-resident taxpayer has limited tax liability where a direct investment is concerned. Income from the sale of shares in German stock corporations is exempted from this in order to prevent German investment funds from being put at a competitive disadvantage due to double taxation agreements
- In respect of investment corporations, the liability for corporate taxes also extends to income from asset management as well as income which is generated by voting shares unless the issue of non-voting shares has been waived

The income is determined as the surplus of income over income-related expenses, whereby all income-related expenses which are economically related to the income, i.e. including general overhead, may be recognised. Income-related expenses and loss carry-forwards may not be deducted from income which is subject to withholding tax.

The tax rate on income which is subject to withholding tax is 15%, including the solidarity surcharge (Solidaritätszuschlag). In respect of other types of income, the tax rate is 15% plus the solidarity surcharge.

An exemption from corporate income tax may be granted upon application by the investment fund to the extent (in the proportion) that the following tax-privileged investors participate:

- Non-profit, charitable or religious investors and comparable foreign investors established in a third country which provides administrative and collection assistance
- Investors who hold their investments pursuant to Rürup or Riester contracts

In respect of German source rental income, the group of tax-privileged investors is being expanded to include:

- German legal entities under public law (in particular pension funds) and
- German companies, partnerships or estates (in particular pension and assistance funds [Unterstützungskassen]) and comparable foreign investors established in a third country which provides administrative and collection assistance.

The investment fund is eligible for a more extensive exemption (i.e. not only a proportionate exemption) from the corporate income tax if only tax-privileged investors may participate pursuant to the terms and conditions of investment. In this case, the special provisions on liability in respect of reimbursed or uncollected taxes must be observed.

An investment fund is exempt from trade tax if:

- its objective purpose is restricted to the investment and management of its funds for the joint account of the unit holders and
- the assets are not actively entrepreneurially managed to a significant extent. Where the investment is in a real estate company within the meaning of the Investment Code, however, active entrepreneurial management is always harmless.

The aforementioned conditions are deemed to be fulfilled if the income derived from active entrepreneurial management is less than 5% of the entire income generated by the investment fund in a given financial year.

c. Taxation of the investors in an investment fund
According to the InvStRefG-RegE, the investor’s so-called investment income is subject to taxation. This concerns specifically

- distributions from the investment fund,
- advance lump-sum amounts and
- capital gains and losses realised from the sale of investment units.

It is only if the investment units are held pursuant to a pension agreement or base pension plan agreement that the investment income is not to be recognised. Recognition of only the advance lump-sum amount is excluded when the units are held

- pursuant to a company pension plan,
- by insurance companies as a part of certain pension insurance plans or unit-linked life insurance policies or
- by health or nursing care insurers for the purpose of securing old-age provisions.

The advance lump-sum amount serves the purpose of avoiding an indefinite tax deferral. It is equivalent to 70% of the average rate on public bonds (base interest rate) as determined by the Deutsche Bundesbank multiplied by the redemption price of the fund units at the beginning of the year. The advance lump-sum amount will be applied if the value of the investment fund has increased and the fund retained its earnings or if the amount of the distributions falls below the advance lump-sum amount.

Neither the partial exclusion rule (Teileinkünfteverfahren) nor the investor privilege rule are applicable to distributions, the advance lump-sum amount or capital gains from the sale of the investment units. However, the partial exemptions depicted in the following table are applicable to stock funds, mixed funds and real estate funds in order to create a lump-sum compensation for the prior corporate income tax burden at the level of the investment fund and for foreign withholding tax:

Type of fund	Investment threshold	Type of investor	Exempted amount
Stock fund	Pursuant to the terms and conditions of investment, at least 51% of the assets are continuously invested in stocks	Private investors	30%
Stock fund	Pursuant to the terms and conditions of investment, at least 51% of the assets are continuously invested in stocks	Business investors Income Tax Act	60%
Stock fund	Pursuant to the terms and conditions of investment, at least 51% of the assets are continuously invested in stocks	Business investors Corporate Income Tax Act	80%
Mixed fund	Pursuant to the terms and conditions of investment, at least 25% of the assets are continuously invested in stocks	Private investors	15%
Mixed fund	Pursuant to the terms and conditions of investment, at least 25% of the assets are continuously invested in stocks	Business investors Income Tax Act	30%
Mixed fund	Pursuant to the terms and conditions of investment, at least 25% of the assets are continuously invested in stocks	Business investors Corporate Income Tax Act	40%
Real estate fund	Pursuant to the terms and conditions of investment, at least 51% of the assets are continuously invested in real estate and real estate companies	All investors	60%
Real estate fund	Pursuant to the terms and conditions of investment, at least 51% of the assets are continuously invested in foreign real estate and foreign real estate companies which invest exclusively in foreign real estate	All investors	80%

In respect of the investment threshold, the following special conditions must be observed:

- The stock holding must be in
  - the stock of a stock corporation which is traded in the official trading segment of a stock exchange or shares of a stock corporation which are listed on an organised market,
  - shares of a stock corporation which is not a real estate company and which is subject to prior taxation in the country in which it is listed,
  - shares in a stock fund in an amount of 51% of its value and
  - shares in a mixed fund in an amount of 25% of its value.
- 51% of the value of the units of a real estate fund is considered to be real estate.
- In the event of a change in the partial exemption quotas, a sale and subsequent repurchase of the investment units will be deemed to have been made.

If a partial exemption for withholding tax is not recognised, the investor may show in his tax statement that the investment fund in fact continuously exceeded the investment threshold throughout the financial year.

d. Withholding tax
A special tax rate of 15%, including the solidarity surcharge, is applicable to an investment fund's income which is subject to corporate taxes and which is subject to a withholding tax. To this end, the person or entity who is liable for the tax deduction (i.e. the person or entity responsible for payment of the tax) must submit a status certificate as an investment fund which may not have a period of validity which exceeds three years. The status certificate may be issued with retroactive effect for a period of up to six months prior to the application.

Where the status certificate is presented within 18 months after the receipt of capital income, the person or entity responsible for payment of the taxes must reimburse the investment fund the amount of the withholding tax to the extent that it exceeds the above-mentioned tax rate.

2. Special investment funds
In principle, the option of taxing special investment funds in accordance with the limited transparency principle is to be retained. However, the definition of special investment funds will place new conditions on them, and modifications will be made in the taxation procedure.

a. Scope of application
An investment fund qualifies as a special investment fund if it fulfils the conditions for an exemption from trade tax and does not de facto seriously infringe certain investment rules. These conditions are essentially the same as the criteria which were introduced by the AIFM Tax Act and which must be complied with by all investment funds under current law, whereby in particular the threshold of 10% for impermissible assets (Schmutzgrenze) was retained. In derogation to the currently applicable law and in addition to certain other modifications, the omission of a redemption option for the investor cannot be remedied by an admission to trading on a stock exchange. Furthermore, the special investment fund must be managed by itself and not simply subordinated to the administrator of a supervisor, and the scope of securities which may be acquired is restricted to securities within the meaning of Section 193 of the Investment Code. The acquisition of units in an investment fund will also be subject to more extensive conditions.

The condition that the special investment fund have a maximum of 100 investors who are not natural persons remains in place. An indirect participation by natural persons via a partnership is, in contrast to prior the legal situation, no longer permissible. However, the InvStRefG-RegE sets out a staggered grandfathering clause for natural persons who are currently participating indirectly in a special investment fund. Units which were acquired on or after 24 February 2016 are grandfathered until 1 January 2020. Units which were acquired prior to the aforementioned date are grandfathered until 1 January 2030. Where a partnership participates in a special investment fund, the partnership must enter the units held by the partners in a registry of units (Anteilsregister) by no later than six months after the acquisition of the units. The partnership is therefore subject to an obligation to file a notification. Furthermore, the special investment fund must ensure that the maximum number of investors permissible is not exceeded and that no natural persons participate in the fund and in particular provide for a special right of termination for this purpose in its terms and conditions of investment. The violation of the special investment fund's obligations in connection with the identification of the members of the partnership is punishable as an administrative offence.

b. Taxation of the special investment fund
In principle, special investment funds are also subject to the tax rules applicable to investment funds. However, the obligation to pay corporate taxes may be avoided by exercising the so-called transparency option.

The condition for this is that, in respect of its domestic participation income, the special investment fund irrevocably declares vis-à-vis the depositary as the entity obliged to pay the withholding tax that the tax certificates for distributions will be issued for the benefit of the investors in the special investment fund. In addition to the details which are already required to be provided in the tax certificate, further details concerning the investors and their participation in the special investment fund must be included. In respect of the rules governing withholding taxes, the generally prevailing rules are applicable on an individual investor basis. In order to enforce the withholding tax, a staggered liability will be introduced, pursuant to which – subsidiary to the liability of the person or entity responsible for paying the tax and the liability of the investor – the special investment fund´s legal representatives will also be liable for withholding taxes which have illegitimately not been withheld.

Domestic real estate income is exempt from taxation where the special investment fund collects, and pays the withholding tax on distributed dividends or payments which are equivalent to dividends and issues the investors tax certificates.

Special investment funds are always exempt from trade tax.

The determination of the income generally follows the currently applicable provisions, although losses incurred from financial derivatives are to be deducted as direct costs from the capital gains generated by the sale of units if there is a conceptual design. This is intended to avoid capital gains from the sale of units from being able to be received tax free while at the same time being entitled to claim tax deductions for losses incurred from counterpart forward transactions.

c. Taxation of investors in a special investment fund
As was the case prior to the reform, the investors are taxed on

• the distributed income,
• the income which is equivalent to distributed income and
• capital gains and losses from the sale of units in the special investment fund

in accordance with the respective provisions applicable to them.

The definition of payments which are equivalent to distributed income closely follows current law. Investment income whose retention is exempt from taxation primarily includes income from option writer premiums and capital gains from the sale of shares, forward transactions, bonds, investment certificates and special investment fund certificates. Income from swap transactions is not exempt from taxation if the capital flow is based on interest or dividends. The purpose of this rule is to prohibit tax structures which circumvent the taxation of dividends and interest by using such swaps. The fact that all tax-exempt earnings which may be retained are deemed to have been distributed to the investors at the end of the special investment fund's 15th financial year after it has received the income if this income is positive after the loss carry forwards have been deducted and if the earnings have not been distributed makes this particularly complex.

Furthermore, the special investment fund's revenues and income-related expenses are to be allocated to the investors in proportion to their holdings. Income which is equivalent to distributed income will therefore be attributed to the investors even if the investor sells the units prior to the relevant cut-off date. This aspect will also pose significant problems for capital management companies and investment companies.

The partial exclusion rule and the investor privilege rule may be applicable to foreign dividends and capital gains from the sale of domestic and foreign shares which are attributed to the investor as domestic participation income if the transparency option has been exercised, provided the investor fulfils certain personal and other objective criteria.

Where the transparency option has not been exercised, a flat amount of 60% of the domestic participation income will be tax exempt. A full tax exemption is applicable if the investor is subject to the Corporate Income Tax Act and the special investment fund is not eligible to claim a reduction pursuant to a double taxation agreement because the maximum amount of the withholding tax under that agreement is less than 15%. These rules also apply to domestic income from real estate and other domestic income, but the flat-rate tax emption is 20% in these cases.

Furthermore, it may be possible to assert tax exemptions based on double taxation agreements and the imputation method pursuant to the Foreign Transactions Tax Act. As is the case for investment funds, the system of partial tax exemption may also be applicable. However, with the exception of the flat-rate tax exemption when the transparency option has not been exercised, which has been described above, the tax exemptions are conditional on the special investment fund determining the absolute value of the fund's capital gains from shares (Fonds-Aktiengewinn), profits subject to a double taxation agreement (Fonds-Abkommensgewinn) and profits subject to a partial tax exemption (Fonds-Teilfreistellungsgewinn) each time its assets are assessed on a pro rata basis for each special investment fund unit and notifying the investor thereof.

II. Transitional provisions

The new system of taxation is applicable from 1 January 2018, irrespective of what the investment fund's financial year is. Investment funds which have a financial year that does not coincide with the calendar year will have to make 2017 a short financial year ending on 31 December 2017 for tax purposes. An extension of the deadline for the final publication of the tax assessment base pursuant to Section 5(1) sentence 1 no. 3 sentence 1 of the German Investment Tax Act to 31 December 2018 applies.

Units of investment funds and shares in capital investment companies within the meaning of the Investment Tax Act or in investment vehicles which fall within the scope of application of the new Investment Tax Act for the first time on 1 January 2018 will be deemed to have been sold at the end of 31 December 2017 and acquired again starting on 1 January 2018. The capital gains and losses shall not be recognised until the time the units are actually sold.

For units in investment funds which were acquired prior to 1 January 2009, i.e. prior to the introduction of the flat rate withholding tax, the increase in the value of the units realised in the period between the acquisition and 31 December 2017 will not be subject to taxation, providing the units have not been held as a business asset since the acquisition. On the other hand, the increases in the value of the units realised from 1 January 2018 onward are subject to taxation if the capital gains exceed the tax-exempt amount of kEUR 100.

III. Conclusion

The reform of taxation of investments will represent the most important turning point in taxation for capital management companies, investment companies, product providers, depositaries and investors since the introduction of the Investment Tax Act. In our view, it will be important to continue to convince investors of the advantages of investing assets in investment funds. We also recommend preparing for the reform early on and modifying IT systems in order to be able to effectively cope with the significant additional work and effort.

RADAR Regulatorischer Informationsdienst VÖB SERVICE in new cooperation with Deloitte.

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Editorial deadline: March 24, 2016, 12:00 p.m.

Note

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Issued 4/2016