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Current Regulatory Developments

Effects of the "New" German Investment Regulation (AnlV)

1. Introduction

When the German Capital Investment Code (KAGB) came into force it became necessary to amend the German Regulation on the Investment of Restricted Assets of Insurance Undertakings (AnlV) as well as to update the Regulation's wording, and the legislator took this opportunity to substantively amend the legislation as well.

On 25 February 2015 the German Federal Government adopted the regulation amending the Investment Regulation and the nearly identical German Pension Fund Investment Regulation (PFKapAV), which were published in the German Federal Law Gazette on 6 March and entered into force on 7 March. The final version of the Investment Regulation contains several improvements in comparison to the originally published draft version of May 2014, which was the subject of intensive discussions throughout the industry.

In the following, we briefly present the most significant changes of the adopted Investment Regulation insofar as they are relevant to capital management companies. Our presentation follows the Regulation's structure, which specifies the general eligibility of certain types of assets and asset classes in Section 2; sets out the permissible mix, i.e. the maximum percentages for the respective asset classes with regard to the guarantee assets (Sicherungsvermögen) and the restricted assets in Section 3; and explains the diversification, i.e. the maximum proportion a single investment or a single debtor or issuer may have in the guarantee assets/restricted assets in Section 4.

2. New Structuring of Asset Classes According to Investment Focus

a. Range of Assets

In respect of the eligibility of types of assets, the revised Investment Regulation foresees a reorganisation of the range of assets that insurance undertakings may invest in as investment assets. Furthermore, this memorandum makes several references to the circular, which must still be published by the German Federal Financial Supervisory Authority (BaFin) concerning several subjects (update of the circular 4/2011), although to date there is no such draft. BaFin seems to deal with this issue with low priority.

The following provisions represent the most important changes which affect investment funds, either directly or indirectly:

1. Loans to Public Debtors (Sec. 2 (1) No. 3 German Investment Regulation (AnlV))

In respect of investments as loans to public debtors, the requirement of a minimum risk weight in accordance with the provisions applicable to credit institutions for determining equity requirements was deleted. Instead, the insurance undertakings should base their investment decisions on their own ratings and credit risk assessments. The forthcoming circular is supposed to set out the detailed rules governing this matter. However, logically, this means that, for example, Greek bonds may generally be acquired, but the insurance undertaking (or the capital investment company investing on their behalf) must assess the bonds and demonstrate that the general conditions for acquisition (maximum security and profitability while maintaining liquidity at all times) pursuant to Sec. 54 (1) German Act on the Supervision of Insurance Undertakings (VAG) have been satisfied on the basis of its own rating. This may result in such assets no longer being eligible for acquisition under the new regime.

2. Loans to Undertakings (Sec. 2 (1) No. 4 German Investment Regulation (AnlV))

Pursuant to Sec. 2 (1) No. 4c German Investment Regulation (AnlV), loans may now be made to undertakings without having to comply with the stricter rules of Sec. 2 (1) No. 4a German Investment Regulation (AnlV), provided that the undertaking (or credit institution) has its registered office in an EEA member state or is a full member of the OECD, the loan is sufficiently secured in rem or sufficiently contractually secured and has at least a speculative grade rating. It is therefore possible to invest in start-ups and infrastructure undertakings (and other project undertakings) as well as in high yield loans. To compensate for the higher risks associated with such investments, a maximum threshold of 5% is foreseen for such investments (Sec. 3 (2) No. 3 German Investment Regulation (AnlV)) and they are now included in the venture capital threshold of 35% (Sec. 3 (3) German Investment Regulation (AnlV)). On the one hand, the expanded loan opportunities have the effect of expanding the range of eligible assets, but on the other hand this will in all likelihood also entail higher requirements being placed on the management of credit risk. Past experience in connection with hedge funds has shown that insurance undertakings have not found it profitable in the past to make the greater efforts required for investing in hedge funds because they considered the 5% cap on eligible investments to be too marginal. This applies all the more given the background that, in the future, the German Investment Regulation will apply only to smaller insurance undertakings or (via the correspondingly worded Regulation) pension funds. However, it is also possible that, due to the available expertise on loans, expansion in the high yield area may be considered less demanding.

3. Participating Interests (Sec. 2 (1) No. 13 German Investment Regulation (AnlV))
The conditions for acquiring participating interests pursuant to Sec.2 (1) No. 13 German Investment Regulation (AnlV), i.e. direct or indirect investments in undertakings not listed on a stock exchange, which have a business model and assume entrepreneurial risks, were recast. Eligible participating interests in operating undertakings were expanded by the inclusion of regulated private equity funds (Sec. 2 (1) No. 13b German Investment Regulation (AnlV)) in the form of closed-ended Alternative Investment Funds (AIFs) with corresponding investments, including European venture capital funds and European funds for social entrepreneurship. Previously, these could only be acquired via the opening clause. The explanatory memorandum to the German Investment Regulation (AnlV) makes clear that investments by the closed-ended AIF in the equity of unlisted undertakings, in quasi-equity instruments (e.g. subordinate loans or profit participation rights/mezzanine financing instruments) as well as other instruments for financing undertakings, is allowed, provided these have been subject to a thorough due diligence examination and are monitored. On the other hand, the pure buy-and-hold strategy with regard to loans is not to count amongst the eligible instruments. The acquisition of funds of private equity funds (Dach-Private-Equity-Fonds) in corresponding target funds is not regulated, i.e. the target funds do not have to meet the requirements of Sec. 2 (1) No. 13 German Investment Regulation (AnlV). To prevent circumvention in such cases, the Federal Financial Supervisory Authority (BaFin) will specify more detailed requirements for the funds in a circular.

In contrast to the draft version of the Investment Regulation, not only funds of capital management companies, that have a licence pursuant to Sec. 20 German Capital Investment Code (KAGB) (or a comparable foreign permit), may be acquired, but also funds of undertakings registered pursuant to Sec. 44 German Capital Investment Code (KAGB) or comparable foreign undertakings (in contrast to inter alia closed-ended public real estate AIFs, see below). The authorities attribute any funds to the closed-ended funds when the units cannot be redeemed at least once per annum. In this aspect they thus deviate from the changes which have since been made to the German Capital Investment Code (KAGB) in respect of the definition of closed-ended funds and rely on the Code's original wording instead.

The closed-ended real estate funds that could previously be acquired as a part of the equity investment portfolio have now been included in Sec. 2 (1) No. 14 German Investment Regulation (AnlV), which governs all real estate investments. The Regulation is thereby given a much clearer structure.

4. Real Estate (Sec. 2 (1) No. 14 German Investment Regulation (AnlV))
Real estate investments were expanded by the acquisitions of participating interests or shares in domestic special AIFs which invest in real estate, heritable building rights, usufruct in real property and real estate investment undertakings. As before, closed-ended public AIFs focusing on real estate may be acquired, but not open-ended public AIFs. This is conditioned on the fund being managed by an undertaking having its registered office in the EEA, or by an undertaking which has a licence pursuant to Sec. 20 German Capital Investment Code (KAGB) or which has a comparable licence pursuant to the applicable law. A registration pursuant to Sec. 44 German Capital Investment Code (KAGB) does not suffice for this purpose.

The open-ended and closed-ended AIFs subject to Sec. 2 (1) No. 14c German Investment Regulation (AnlV) must directly or indirectly invest in assets typical for public real estate investment funds (Publikums-Immobilien-Sondervermögen). However, the Investment Regulation does not take a position on the issue of the volume in which the funds must be invested in the aforementioned assets in order to fall within the scope of Sec. 2 (1) No. 14 German Investment Regulation (AnlV). This is important because the entire fund must be included in the real estate threshold, stipulated by Sec. 4 (4) German Investment Regulation (AnlV), of 10% for each real property/fund, i.e. the individual funds may not constitute more than 10% of the guarantee assets and the other restricted assets. Otherwise, in contrast to all other fund investments, e.g. in respect of issuer thresholds (Sec. 4 (1) German Investment Regulation (AnlV)) or other ineligible investments, the funds need not be transparent. However, we assume that, in the light of the provision's object and purpose, the Federal Financial Supervisory Authority (BaFin) will set out more detailed rules governing the minimum volumes of the real estate investments in the funds in its circulars.

5. UCITS

The eligibility of UCITS as an investment acquisition is, pursuant to the new version, now governed by Sec. 2 (1) No. 15 German Draft Investment Regulation (AnlV-E). Previously, all investment assets under the old law, with the exception of pension investment funds (Altersvorsorge-Sondervermögen), were included in this provision. Restrictions in respect of the investments of the UCITS were not foreseen, i.e. complex investment strategies ("Newcits") are generally able to be designed.

6. Special Funds with Fixed Terms and Conditions of Investment (Sec. 2 (1) No. 16 German Investment Regulation (AnlV))

All domestic open-ended special AIFs (offene Spezial-AIF) with fixed terms and conditions of investment (with the exception of real estate funds) are now included in Sec. 2 (1) No. 16 German Investment Regulation (AnlV). These funds correspond to the special funds which had previously been governed by the German Investment Act (InvG) and which were entirely eligible for insurance undertakings. If the funds invest in target funds, these must also satisfy the conditions for acquisition applicable to insurance investments. Comparable foreign EU AIFs may likewise be acquired by the insurance undertaking, provided the undertaking managing them has a licence which is comparable to Sec. 20 German Capital Investment Code (KAGB). In the draft version of the Regulation, it was only permissible to acquire such funds if they had an investment policy comparable to a UCITS' investment policy. This provision was dropped from the adopted version due to pressure from the industry. However, all funds falling within the scope of No. 16 must be transparent and sufficiently fungible. Furthermore, it is expected that the regulators, as a continuation of their administrative practice so far, will adopt more detailed regulations on the eligible investment assets of special AIFs and the investment thresholds to be observed.

7. Alternative Investments (Sec. 2 (1) No. 17 German Investment Regulation (AnlV))

Sec. 2 (1) No. 17 of the Draft Investment Regulation (AnlV-E) (other funds) is a catch-all provision for insurance undertakings for the acquisition of funds which are neither public real estate investment funds nor fall within the scope of the other above-mentioned provisions. This means inter alia that the prohibition of the acquisition of open-ended real estate investment funds, which had only previously been set out in the circular 4/2011, now has the force of law. However, such funds which were acquired prior to the Regulation's coming into effect may continue to be held; they will be attributed to the real estate investments.

In addition, special funds which do not have fixed terms and conditions of investment, as well as open-ended other public special funds (offene Publikumsfonds Sonstige Sondervermögen), funds of hedge funds (Dachhedgefonds), mixed special funds (Gemischte Sondervermögen) and, owing to the deletion of applicable restrictions, now also pension investment funds, whereby the latter will likely be of only limited importance because they are no longer eligible investments under the new law, also fall within the scope of Sec. 2 (1) No. 17 German Investment Regulation (AnlV). Funds which invest solely in non-securitised loans may – in accordance with the industry's request – now be acquired under the new law. But closed-ended funds of any kind (except for the private equity funds and real estate funds falling within the scope of Nos. 13 and 14) as well as comparable EU investment funds now also belong to the eligible investments. In turn, a condition for the acquisition of any of the funds falling within the scope of No. 17 is that the fund is managed by an undertaking which either has a licence pursuant to Sec. 20 German Capital Investment Code (KAGB) or a comparable licence pursuant to the applicable law of the EU Member State in which it is located.

b. Mix Thresholds and Diversification (Sections 3 and 4 German Investment Regulation (AnlV))
In addition to the conditions for acquisition, the wording of the quantitative restrictions (mix) was revised and in part substantively recast.

1. Threshold for Alternative Investments
Pursuant to Sec. 3 (2) No. 2 German Investment Regulation (AnlV) a new cap for all assets falling within the scope of No. 17 of 7.5% applies to guarantee assets and the other restricted assets (threshold for alternative investments), thereby replacing the individual thresholds of 5% for hedge funds and commodity risks, respectively. However, other hedge fund and commodity risks (such as securitised certificates) also fall within the scope of the new threshold as well as – and this is new – assets which are held via a fund mentioned in Sec. 2 (1) No. 16 German Investment Regulation (AnlV) (funds with fixed terms and conditions of investment) and which cannot be attributed to one of the numbers of the asset catalogue. This has the consequence that, where possible, capital management companies that manage special funds for insurance undertakings should not make any investments which are ineligible from the point of view of an insurance undertaking on behalf of the fund. If, however, such an investment is made in a fund in an isolated case, it must be included in the investment reporting and identified, in order to enable the insurance undertaking to be able to correctly determine its mix threshold at the corporate level. In this connection it may be questionable, for example, whether derivatives, which do not serve as hedges, may still be acquired by a special fund at all. In this respect the explanatory memorandum to the Investment Regulation provides clarity; according to this memorandum, derivatives do not need to be included in the threshold for alternative investments, but do, however, need to be included in the general venture capital threshold. On the other hand, loans which are rated with speculative grade, which would count towards the threshold for alternative investments if they had been acquired directly, may be acquired without restriction via special funds with fixed terms and conditions of investment.

The inclusion of other public special funds and mixed public special funds in the threshold for alternative investments is certainly to be seen as more restrictive in comparison to the old law because, under the old law, they could be acquired without restriction. Infrastructure funds also fall under the above-mentioned threshold, so that, contrary to the legislator's intent of easing investments in infrastructure, their acquisition will probably be possible only in limited cases.

It is also unclear what is to be understood by the term "hedge funds risk" because, in contrast to the old law, the legislator did not foresee a definition, for instance by a reference to Sec. 283 German Capital Investment Code (KAGB). It is therefore likely that it will be left up to the Federal Financial Supervisory Authority (BaFin) to bring clarity to the situation by way of its future circular.

2. Venture Capital Threshold
The above-mentioned venture capital threshold pursuant to Sec. 3 (3) German Investment Regulation (AnlV), which is set at 35%, includes the direct and indirect investments falling within the scope of Sec. 2 (1) Nos. 9, 12 and 13, i.e. subordinate loans, shares and private equity funds. Furthermore, investments in alternative investments (No. 17) as well as loans falling within the scope of Sec. 2 (1) No. 4c (sub-prime securitised loans) are included via the threshold. Within the venture capital threshold unlisted subordinate loans and funds may not comprise more than 15% of the guarantee assets and the other restricted assets.

Furthermore, the increased market risk potential of funds having more than the simple potential market risk due to the use of derivatives is to be attributed to the venture capital threshold. However, this applies only to UCITS and special AIFs with fixed terms and conditions of investment. The provision is not relevant for funds falling within the scope of Nos. 13 and 17 because they are in any case entirely included in the venture capital threshold. However, this rule also does not apply to real estate funds, which is certainly related to the fact that, in respect of open-ended and closed-ended real estate funds, the use of derivatives is, according to the explanatory memorandum to the Investment Regulation, in any event only permitted for hedging purposes, so that it may not be related to any leverage factor.

3. Real Estate Threshold

The threshold for real estate, which was kept at 25%, includes, in addition to direct investments in real estate, which was already included, investments in REITS and in real estate holding undertakings, direct or indirect loans to the latter and real estate held by qualified special funds and investment undertakings. However, the eligible investment assets are now defined in greater detail in Nos. 14c (real estate funds) and 16 (open-ended special AIFs with fixed terms and conditions of investment), whereby the open-ended special AIFs must additionally satisfy the requirements applicable to real estate funds pursuant to No. 14c (inter alia the registered office of the fully licenced capital management company must be in the EEA). Funds of real estate funds (Immobiliendachfonds), for example, also fall within the scope of this provision, provided the target fund satisfies the conditions of Sec. 2 (1) No. 14c German Investment Regulation (AnlV). Loans (to real estate holding undertakings) other than those mentioned in Sec. 2 (1) No. 4b German Investment Regulation (AnlV) will not be included in the real estate threshold, even if they predominantly represent real estate risks.

4. Diversification

The debtor-related restriction (diversification) of 5% of the restricted assets for each issuer/debtor has been retained under the new Regulation in Sec. 4 (1) German Investment Regulation (AnlV). The investments of the ten largest issuers, which are held via open-ended investment funds (without real estate funds), are to be counted towards this threshold and the other thresholds mentioned in Sec. 4 German Investment Regulation (AnlV). The restriction of investments in the same undertaking to the amount of 1% pursuant to Sec. 4 (4) German Investment Regulation (AnlV) was extended to investments in private equity funds and other closed-ended investment funds pursuant to Sec. 2 (1) No. 17 German Draft Investment Regulation (AnlV-E). If target funds are held, the requirements must be calculated. Real estate funds remain exempt from the obligation.

c. Protection of Existing Portfolios

The provisions governing the transition period foresee protection for public real estate investment funds as well as for investments in comparable foreign investment funds which were acquired prior to 8 April 2011, and also for private equity funds which do not fulfil the new requirements. The classification of open-ended special AIFs with fixed terms and conditions of investment was, in accordance with common practice, retained when the Draft Regulation was revised, so that, in the final version of the Investment Regulation (AnlV), there was no need to include transitional arrangements for open-ended special AIFs.

III. Conclusion

In comparison to the draft version, the adopted Investment Regulation has far-reaching facilitations.

It can be assumed that the new Investment Regulation will have marked effects on insurance undertakings and the investment of restricted assets, on the one hand, and the developers of capital investment products, on the other. Capital investment companies are called on to increasingly tailor their capital investment products to the needs of and investment restrictions on insurance undertakings/investors. In addition, it can be expected that the transparency requirements will lead to increased obligations concerning the monitoring of the investments and increased reporting duties. Investments already acquired are protected only to a very limited extent.

It is to be welcomed that the final version of the Regulation, in contrast to the Draft Regulation, addresses the issue of eligibility in respect of the investment products of a capital management company that is subject to licencing, even though this was limited to private equity funds, which are so far relatively rare in the investment universe. For all other funds, the capital management company managing the funds must be fully licenced pursuant to Sec. 20 German Capital Investment Code (KAGB) or must be fully licenced in accordance with a comparable foreign law. This results in considerably restricting the investment universe of insurance undertakings.

The clarification of the eligibility of closed-ended real estate special AIFs and the concretisation of open-ended special AIFs with fixed terms and conditions of investment is welcome. However, for funds, the requirement that the capital management company has to have its registered office in the EEA is mandatory. In contrast to direct investments, third State funds are ineligible.

In respect of the new asset classes and the capital investment circular, which is still to be published by the Federal Financial Supervisory Authority (BaFin), in particular the issue of additional requirements, e.g. in respect of managing credit risk or the more detailed requirements to be fulfilled by real estate funds and how the Federal Financial Supervisory Authority (BaFin) will specify circumstances and facts requiring interpretation, remains very interesting.

For small insurance undertakings, whose annual booked gross premium income is less than EUR 5 million or whose gross actuarial provisions are not more than EUR 25 million, calculated in accordance with the Solvency II requirements, the Investment Regulation will have to continue to be observed in respect of their investments of restricted assets, assuming the current state of play.

For large insurance undertakings the new Investment Regulation is only a transitional rule; when the Solvency II requirements will take effect, they will no longer be subject to the new Investment Regulation's regime, but rather will essentially only have to comply with the principle of entrepreneurial caution.

Consultation on the Depositary Circular

1. Preliminary Remarks

The German Federal Financial Supervisory Authority (hereinafter referred to as "BaFin") published the long awaited consultation regarding the depositary circular on its website on 13 February 2015. Comments may be submitted until 27 March 2015. With this publication, the (preliminary) close to this process draws near, which began in November 2013 with the first discussions on adjusting the depositary circular to reflect the new regulations of the German Capital Investment Code (KAGB). Future amendments to the circular are already anticipated as the implementation of the revised Investment Directive (UCITS V) will result in changes to the depositary's function. These changes will entail consequences for BaFin's administrative practices, as described in the circular.

In the following, we would like to outline the most significant points in which the draft prepared for the consultation differs from the most recently discussed version of April 2014.

In this context, we will explain the amended regulations regarding the experience of governing bodies or managers, the look-through approach applied to special purpose companies, the custody of shares in target funds and assets held in sub-custody, cash-flow monitoring and investment limits including assessing market risk limits, the audit models for monitoring share prices and investment limits as well as the individual specific issues related to circumstances subject to monitoring obligations.

2. Experience of Governing Bodies or Managers

In the consultation draft, BaFin specifies the special requirements of professional suitability for governing bodies or managers for the appointment of a depositary with regard to the depositary function. According to this, there must be the relevant legal and economic expertise at hand in terms of the assets to be acquired for the fund and the relevant legal and actual relationships in terms of the countries where the assets are located.

3. Special Purpose Companies

With regard to the use of special purpose companies by the capital management companies, BaFin clarified that the look-through approach refers only to the safe-keeping obligations of the depositary. In this respect, the safekeeping obligations stipulated in Art. 89 (3) and Art. 90 (5) of the AIFM Level 2 Regulation are applicable to direct and indirect investment structures. Monitoring cash flows, however, is exempt from the look-through approach. In this way, BaFin addresses a relevant statement made by the ESMA in the FAQ: Application of the AIFMD (question 1 in the "Depositaries" section, dated 24 July 2014).

4. Custody

a. Shares in Target Funds Held in Custody

Financial instruments that can be held in custody must always be held in custody by a depositary. It was unclear for a long time how to handle shares in foreign target investment assets that are only assigned to an owner via a register managed by the issuer or an appointed body. In these cases, the actual owner (fund of funds) or the capital management company (KVG) acting on the owner's behalf is entered in the register. BaFin explains that in cases where the direct registration pursuant to the national law applicable to the target fund is the only option for custody, the shares are not capable of being held in custody by the depositary. Assets that cannot be held in custody, which include the above-stated shares or derivatives, are to be listed in an inventory register that must be kept up to date at all times.

b. Sub-custodian

In the draft, BaFin holds that the current standard practice of holding customer assets in Depot B accounts separately from the depositor's own assets and from the sub-custodian's own assets is thought to be possible under specific conditions, provided that this does not deviate from ESMA interpretations of Art. 99 of the AIFM Level 2 Regulation. In order to comply with Art. 99, in such cases, the assignment of assets in accounting terms must be documented clearly at all times. Furthermore, this type of safe-keeping of assets may not result in any additional custody-related risks in accordance with the applicable law in the country where the depositary is located. With regard to this issue, BaFin introduced a variable, which will be addressed when the circular is revised after the final ESMA directive will be published during the second quarter. For more information on the options that were introduced in the ESMA draft, please refer to the "Safe-keeping of AIF" section in this newsletter.

5. Monitoring Cash Flows and Investment Limits

a. Cash Flows and Audit Intervals

In view of monitoring cash flows, the draft states clearly that the depositary must identify the previous workday's cash flows on workdays where the cash flows could be inconsistent with the legal and contractual requirements for the AIF. This can be restricted to cash flows that are subject to a significant risk, i.e. cash flows that exceed the reasonable threshold, which is to be determined, or that originate from a specific source, for example.

The option of ex-post monitoring of cash flows is only applicable if the depositary does not perform instructions of the capital management company (KVG) within the context of processing transactions and other payment procedures. The principle that instructions may only be followed if they comply with the law and investment requirements (Sec. 76 (2) / Sec. 83 (5) German Capital Investment Code (KAGB)) continues to apply in this context. With regard to the time at which the depositary is to conduct its legality assessment, BaFin issued a statement in the section "Monitoring Investment Limits." According to this, in this case, monitoring activities are to be conducted ex ante and an instruction that violates the law or investment requirements may not be carried out or must be cancelled. An ex-post control is sufficient in cases where prior control was not possible due to market conditions (i.e. securities transactions that are processed automatically without the involvement of the depositary) or if a delay in the transaction process is not in the interest of the investors. Even in the event of subsequent control, an escalation procedure must be initiated in the event of violations.

The basic principle of ex-ante controls can be avoided for AIFs, if applicable, by assigning a depositary that, in the absence of own accounts/deposit accounts management, does not perform any instructions or only carries out limited instructions of the capital management company (KVG). In this case, transaction monitoring takes place ex post based on the cash flows identified by the depositary and the proof of monitoring ownership structure provided by the capital management company (KVG).

b. Assessment of Market Risk Limits

In its depositary circular, BaFin subjected the monitoring of legality to an expenditure/utilisation ratio. As a result, the market risk limit (200% limit) is no longer interpreted as the investment limit by BaFin; in this context, the depositary could opt to forgo the assessment of risk measurement according to the qualified approach. This is no longer possible pursuant to the new legal requirements, so that the depositary is required to assess the risk exposure to an appropriate extent using its own model or the capital management company's (KVG) model.

6. Audit Models

a. General Provisions

In its comments on audit models, BaFin presented general provisions for conducting investment limit controls. According to these, BaFin refers to the regulation stipulated in Art. 95 (a) of the Level 2 Regulation, which states that the procedure for investment limit controls must correspond with the type, scope and complexity of the AIF. In particular, the depositary itself must conduct appropriate and comparative procedures on the basis of the required data provided by the capital management company (KVG). BaFin also explains that the depositary must perform audit activities itself or via an independent auditor on the capital management company's (KVG) business premises and on its systems and its outsourcing companies. These audits were previously reserved for model 1, but are not included as a general requirement.

b. Model 1

The ban on outsourcing monitoring activities was accounted for by BaFin in its latest draft of the depositary circular by means of limiting the use of the capital management company's (KVG) systems to the provision of the technical platform. In this context, the depositary was to parametrise and to test this system itself and to maintain the data with the same diligence as it applies to maintaining its own system. This would not have complied with the article on cooperation between the capital management company (KVG) and the depositary in model 1, according to which the depositary could refer back to the fund accounting system of the capital management company (KVG) for audit activities under consideration of specific requirements. The above-stated requirement was dropped in the consultation draft. As a result, it remains to be seen to what extent the capital management company's (KVG) systems can actually be used in practice without violating the ban on outsourcing according to Secs. 73 (4) and 82 (4) German Capital Investment Code (KAGB).

c. Monitoring Share Valuation

Based on the new legal ban on outsourcing monitoring activities, with regard to monitoring share valuation, BaFin provides for the use of an appropriate alternative system beyond the capital management company's (KVG) fund accounting system or an appropriate procedure independent of the capital management company (KVG). It will also have to be determined how the share valuation structure can be implemented in practice while possibly retaining model 1. In this respect and in addition to the deposit accounting system, the management of own assets that cannot be held in custody, such as tangible assets, derivatives, source taxes, claims, target funds and company investments, will have to be increasingly applied.

7. Circumstances Subject to Monitoring Obligations

Borrowing according to Sec. 254 German Capital Investment Code (KAGB): With regard to assessing the compatibility of borrowing with proper business management, BaFin provides that the depositary must perform a plausibility check on the process documentation supplied by the capital management company (KVG) for this purpose; an independent appraisal of the factual consequences of the loan on the further development of the fund is not provided for. This is advantageous because, in practice, such an appraisal can only be performed in retrospect; however, in view of the requirements on borrowing, it must be performed ex ante. On the other hand, the capital management companies (KVG) must now prepare process documentation on this issue, which does not yet exist in many cases, and provide this to the depositary.

a. Management of Real Estate Included in a Real Estate Fund

In this section, BaFin noted that with regard to a closed-ended fund, Sec. 260 German Capital Investment Code (KAGB) (sale price may not be significantly below the value determined by an external assessor) does not apply, but that compliance with standard market prices must be assessed in advance.

b. Monitoring Remuneration and Reimbursement of Expenses

The depositary may only pay the capital management company (KVG) management fees and may only reimburse expenses within the legal and contractual framework. In the case that accounts are not managed by the depositary, the circular states that it must now be ensured by way of appropriate contractual agreement, which stipulates that the account-holding institution may only pay the remuneration or reimburse expenses to the capital management company (KVG) with the consent of the depositary.

c. Reimbursement of Expenses/Transaction Costs

In connection with submitting a claim for reimbursement of expenses, the depositary must not only check the invoices submitted to ensure they are mathematically correct but also subject the invoices to a plausibility check, which should include ensuring that the invoices are in line with market conditions, if possible. This also includes transaction costs, which, according to BaFin, also include broker, delivery, foreign currency or notary costs. In the previous draft, a mandatory check of transaction costs' consistency with market conditions was also provided for. This provision was aimed at controlling the submission of excessive invoices. This requirement was enhanced by the new regulation.

8. Summary

Overall, in comparison with the discussion draft from April, the intended amendments of the consultation draft will provide relief on issues such as checking transaction costs or the possibility of retaining model 1 for assessing investment limits. Tightening measures were also included, however, on matters such as own audits, which are to be performed on the capital management company's (KVG) business premises, no longer being restricted to model 1. BaFin at least accommodated the industry by stating that audit model 1 should remain valid, which appeared questionable at first based on the legal ban on allowing depositaries to outsource their monitoring duties to third parties. In this context, it must still be clarified in practice how the structure of model 1 can be further developed, such as by enhanced differentiation between the areas within the model in which the capital management company (KVG) can supply technical and data-related information and where the actual audits are to be conducted.

It is expected that comments from market participants will be submitted within the consultation deadline (in particular from closed-ended fund providers), who fear massive consequences for their business activities based on the call for intensified involvement of depositaries and who will push for changes in view of relief on the above-stated time-specific audit pressure (ex ante control measures). The sub-custody of assets in AIFs continues to remain an unresolved issue; furthermore, changes based on the implementation of the UCITS V Directive are necessary. The draft in its current version is by no means finalised, so that close observation of its further development – as is the case with all regulatory topics – remains necessary.

Safe-keeping of AIF Assets at Depositaries: Asset Segregation in Sub-custody

The update of the depositary circular, which became necessary due to the introduction of the German Capital Investment Code (KAGB), was initiated in the fall of 2013 with a BaFin draft; a second draft was provided in April 2014. On 13 February 2015, the draft of the BaFin's statement on the consultation, now called the depositary circular, was presented. The delay was due to the fact that complete legal certainty could not be ensured with regard to the requirements on assets held in (sub) custody.

This involves the implementation of the regulation stipulated in Art. 99 of the European Regulation 231/2013 (EU) (Commission Delegated Regulation), according to which AIF assets held in sub-custody must be segregated from other assets held for customers (asset segregation). This means that it must be ensured by way of accounts and proof that the assets included in the AIF can be identified at all times and without delay. The asset segregation rule was already the subject of controversial discussions during the negotiation of the AIFMD, which contributed to delays in securing approval for the directive. In order to conclude the process, the responsibility for working out a compromise on this matter was passed on, to be dealt with in the context of negotiations on the Delegated Regulation. France in particular was supposedly very committed to the regulations aimed at improving insolvency protection.

In order to clarify the consequences of this regulation, the current framework for holding securities in custody must be explained: In Germany, one securities deposit account per investor is opened at the institution managing the assets in custody. These generally represent the property that the investor holds in the assets that are maintained in the deposit account, at least as far as these are in the safe-deposit box of the depositary bank (i.e. in individual safe custody) or in collective safe custody (Girosammelverwahrung). This ensures that the assets are not included in the insolvency assets in the event that the bank maintaining the assets in custody becomes insolvent, but rather can be assigned to the investors. If the institution maintaining the assets in custody uses depositaries, it must deposit these assets separately from its own assets in so-called Depot B accounts at the depositary in order to ensure protection for the deposited assets under German insolvency law. In these deposit accounts managed for the depositing bank, all customer assets of the bank are pooled, i.e. a further segregation according to each customer is not necessary under German law. With regard to a (sub) custodian located abroad, in order to ensure that the depositary is aware that the assets held in custody in Depot B accounts are not owned by the depositing bank, this depositary must sign a separate declaration called the three-point statement (Drei-Punkte-Erklärung), in which it recognises the existence of third-party property. This also applies to further sub-custody arrangements with depositaries in the form of a custody chain in general. It is determined on a case-by-case basis if the segregation of customer assets in custody held in omnibus deposit accounts in conjunction with the declaration is sufficient in terms of insolvency law in the country where the relevant depositary is located in order to separate the affected assets from the insolvency assets in the event of insolvency. There are countries that have established regulations where the actual owner of the securities must be identified. This means that the pooled safe-keeping of customer assets is not sufficient or is only sufficient in conjunction with other proof of the customer's identity in order to be able to return the assets to the investor.

Special regulations apply regarding typical broker models because the deposited securities are transferred to the prime broker so that the prime broker is able to conduct securities loans, for example; in such cases, the investor loses ownership and only holds a claim against the prime broker, which is usually an unsecured claim. In such cases, at least the consent of the investor in the special fund is to be obtained due to the enhanced risk involved.

In addition, other regulations apply for safe-keeping securities in securities credited abroad because investors cannot be assigned ownership to the securities based on other civil law related situations, but are assigned rights similar to ownership or possibly only claims based on the law of obligations, which entails various consequences in the event that the depositary becomes insolvent. In order to ensure the protection of assets, the depositary must critically deal with the insolvency law applicable in the respective country where the institution maintaining the assets in custody is located; this is precisely what is stipulated in the version of the depositary circular which is still valid.

In Germany, the regulation stipulated in the Commission Delegated Regulation is not likely to require additional protection, but will entail increased expenditure based on the fact that the depositaries must open additional Depot B accounts for the assets held for AIFs as investors, in addition to the Depot A accounts for their own assets and Depot

B accounts for customer assets. If, as in Germany, the regulations applicable in the countries where the institutions maintaining the assets in custody are located deem the segregation of own assets and customer assets to be sufficient protection against insolvency, an additional segregation of AIF assets from other customers' assets is not necessary. If more extensive segregation according to the individual customer (i.e. according to the capital management company (KVG) or even the individual AIF) is required pursuant to insolvency law regulations, a collective deposit account for all AIFs is also not sufficient, but is already expressly provided for in the framework directive (see recital 40, for example). The regulation could increase insolvency protection for AIFs only from the view point of member states that have not already made provisions for the segregation of own and third-party assets when using depositaries within the context of a custody chain in non-European countries; however, in this context, the simple implementation of the regulation stipulated in Art. 21 (11) d) iii) of the framework directive would have been sufficient as it requires the consistent segregation of own and customer assets, also for sub-custody arrangements. The regulation in Art. 99 of the Commission Delegated Regulation even increases, ceteris paribus, the risk of custody as the maintaining of additional deposit accounts (or other evidence) enhances operational risks.

BaFin shares this view and as a result deemed the German model (including additional documentation for AIF assets) permissible in the draft of the depositary circular subject to any differing ESMA interpretation. In order to obtain legal certainty, BaFin declared that a corresponding alignment with ESMA should be performed.

On 1 December 2014, ESMA released a consultation paper that is to be transferred into guidelines following the consultation; the consultation deadline was 30 January 2015. This paper addresses the requirements regarding the segregation of assets at the sub-custody level. In this context, based on the wording of Art. 99 of the Commission Delegated Regulation, which is viewed as unambiguous in this respect, ESMA views only two models as permissible: Option 1 describes the opening of additional Depot B accounts for the depositaries' AIF assets held in custody at their depositaries, as described above. In these depositary accounts (as in other cases), assets of various AIFs can be held together, also AIFs managed by various capital management companies (KVG). Option 2 goes even further in that it states that combining the assets of various investing depositaries is permissible if the omnibus account includes only AIF assets. This would make the alignment of assets (and their assignment to investors in the event of insolvency) significantly more difficult, introduce additional custody-related risks in comparison to the status quo and would likely be inadmissible from a German point of view. In this respect, if the ESMA does not approve any other alternatives other than the two described above, Option 1 constitutes a "lesser evil" in our opinion.

Parallel to the preparation of the above-mentioned guidelines, ESMA was also working on the delegated act to UCITS V. ESMA published its final advice to the Commission on 28 November 2014 concerning the revision of the Investment Directive, which had as its objective inter alia amending the relevant regulatory requirements governing custodian banks to be in line with the AIFMD; this should provide the basis for the adoption of level 2 measures. It does not contain a provision comparable to Article 99 of the AIFM Level 2 Regulation. Rather, the requirements for custody are primarily distinguished according to the risk exposure of the UCITS in the event of depositary's insolvency. For depositaries located in the EU, the newly inserted Article 22a (3) (d) of the Investment Directive foresees that the Member States are responsible for ensuring that the UCITS assets are protected against insolvency; this is presumably to be accomplished by implementing the requirements in national law. If the depositary is located in a third country, the depositary must evaluate the local insolvency law – which includes obtaining independent legal advice –, and as a rule hold the UCITS' assets in segregated accounts (where applicable together with other customer assets, but segregated from the depositary's assets and the local entity itself), and, where this is not sufficient to protect the assets or is no longer sufficient for this purpose owing to changes in the legal situation, immediately inform the capital management company (KVG). This essentially corresponds to the current situation under German law (taking into account the depositary circular, which is still in force) even though additional procedures must be foreseen for the depositary. By requiring the Member States to ensure the protection of the depositary portfolios against insolvency, the protection of the assets will be significantly increased in comparison to the rules which were adopted for AIFs, even though it is desirable for such rules to be extended to as many client assets (including AIFs) as possible in practice and not restricted to UCITS when the Member States implement the act.

Although neither the AIFMD nor the Delegated Regulation on the custody of assets by third parties offer a satisfactory solution as yet, European law has evolved in respect of funds conforming to the directive. Hope therefore remains that the solution developed here will also provide impetus for amending the AIFM Level 2 Regulation in the near future.

The depositary circular released for consultation does not foresee any clear rules for the delegation of custody functions by the depositary, but rather refers to the ESMA consultation in this regard. Based on the wording chosen, it can be concluded that BaFin considers it more likely that the approach that will be taken is that each depositary bank has to hold the AIF portfolios in segregated depositary accounts, but BaFin also does not appear to exclude the ESMA's alternative model. Currently, intensive negotiations to work out a solution are being conducted at the ESMA level on the basis of the respondents' replies; other approaches, such as those which correspond to the model currently practiced in Germany, are also being considered. However, in light of the state of play today, the most likely scenario is that the solution will resemble one of the two options presented by ESMA (presumably tending towards Option 1).

In practice, this means that by opening additional depositary accounts in all countries in which AIFs are kept, additional costs, among other things, can be expected. In addition, updating procedures and amending the depositary agreements will be necessary. To the extent that collateral management or prime brokerage is made more difficult by these new regulations, alternatives will need to be found or fund strategies will have to be changed. However, parallel to this, the investment industry will need to monitor which additional requirements are placed on the safekeeping of securities by the derogating rules in UCITS V, together with the Delegated Regulation, as well as the revised Markets in Financial Instruments Directive (MiFiD II) and the Regulation on Central Securities Depositories (CSDR). In the course of this, it may be useful to already anticipate these requirements in the context of implementing projects to leverage efficiencies in the project, at least insofar as the relevant rules appear to be sufficiently stable.

The requirements placed on depositaries, their risk management in respect of depositary risks and their organisation and IT – ultimately as a consequence of the lessons learned from the financial crisis – will significantly increase. In the depositary bank business, which has small margins, the sole aim is therefore to implement the requirements as efficiently as possible and otherwise to negotiate adequate participation of the funds in the upcoming price discussions with the capital management companies. In the end, the – hopefully – increased security will also benefit the investors.

Real Estate Valuations in Open-Ended and Closed-Ended Public AIFs – Differences and Similarities

The initial and subsequent valuation of the assets of open-ended and closed-ended public AIFs must generally reflect the asset's **fair market value** pursuant to Sec. 168 (1) German Capital Investment Code (KAGB). The capital management company (KVG) is responsible for carrying out a proper valuation pursuant to Sec. 216 (7) German Capital Investment Code (KAGB).

The **initial valuation** of the real estate must be carried out by an external assessor, regardless of whether an open-ended or a closed-ended real estate AIF is concerned (cf. Secs. 231, 261 of the German Capital Investment Code (KAGB)). The valuation must be carried out by two external assessors, who are independent from each other, if the value of the real estate object exceeds mEUR 50. In this respect it should also be noted that this or these assessor(s) may not be the same as the ones who carry out the annual subsequent valuations. In addition, the assessors' independence is also to be guaranteed by ensuring that their activities for the capital management company (KVG) do not exceed 30% of their respective total income for the financial year. This provision is supplemented by a mandatory rotation of the external assessors. The real estate object's value determined by the assessor is used by the capital management company (KVG) as the comparison price for the purchase price, which may only be exceeded by an insignificant amount. After the acquisition, the capital management company (KVG) must initially use the purchase price of the real estate in the AIF.

In respect of **the subsequent valuation** of the real estate, there are – in addition to the different frequencies of the valuation – further differences between open-ended and closed-ended investment funds. In the context of the management of closed-ended investment funds, pursuant to Sec. 271 (4) in conjunction with Sec. 216 (1) German Capital Investment Code (KAGB), the capital management company (KVG) has the right to choose between an external and an internal valuation provided that a functional separation of the valuation has been ensured, in particular from the areas of portfolio management and compensation policy. In contrast to this, the provisions applicable to open-ended investment funds foresee that the valuation is always carried out by two external assessors (Sec. 249 (1) German Capital Investment Code (KAGB)).

Special rules are also foreseen for open-ended public AIFs in the area of participations in real estate via **real estate companies**. It is mandatory that the valuation of the participation – whether it is the initial valuation or the subsequent valuation – be carried out by an auditor, who must use the property valuation established by one or two external experts (cf. Sec. 236 in conjunction with Sec. 248 German Capital Investment Code (KAGB)). The Institute of Public Auditors in Germany (IDW) has defined the requirements governing the proper valuation of real estate companies in a new standard draft (IDW ES 12), which presents a further development of the Recommendations for Practice 1/2012, which had been in force until that time. After the IDW's Auditing and Accounting Board adopted the draft on 24 February 2015 it was put on the IDW's homepage for consultation and, since this time, must generally be observed by members of the profession. The net asset value method essentially still remains applicable because the value of the property recognised in the company's annual financial statements or its statement of net assets, which is determined by the external assessor(s), continues to be used for open-ended real estate investment funds, even though the value of the real estate company is to be determined according to the generally recognised principles applicable to the valuation of participations in undertakings. According to this method, the net asset value of a real estate company is determined and then adjusted by so-called valuation-relevant factors, such as deferred taxes or capital gains tax. Closed-ended public AIFs, on the other hand, are not subject to any such requirements.

The capital management company (KVG) managing the open-ended as well as the closed-ended investment funds is obligated to prepare internal **valuation guidelines** (Sec. 169 (1) German Capital Investment Code (KAGB)). These must include a description of the duties, tasks and responsibilities of all parties taking part in the valuation. The methods used to assess the various asset classes should also be set out and described in the valuation guidelines, and their suitability should be justified; in this context it must be demonstrated that the selected valuation methodis recognised in the relevant market. Accordingly, a description of measures to guarantee the proper and independent valuation is also to be included in the valuation guidelines and appropriate control measures to ensure compliance with the valuation guidelines are to be implemented. In addition, the internal valuation processes must be explained and the dates of the valuation fixed. Furthermore, the documentation and retention obligations must be observed.

Thus, closed-ended and open-ended public AIFs are subject to partially different regulatory requirements when it comes to the valuation procedures. The challenges arising from the interplay between different potential market participants (capital management companies, real estate assessors, assessors for participations in undertakings and auditors), however, concern both areas.

The following table provides an overview:

		Open investment management company	Closed investment management company
Initial valuation of real estate	Value > 50 mio.	2 external valuators	2 external valuators
	Value ≤ 50 mio.	1 external valuator	1 external valuator
Subsequent valuation	Real estate	2 external valuators	Internal or external valuation possible
Initial valuation	Real estate company	1 auditor & 1 external valuator (real property value ≤ 50 mio.)	1 external valuator (company value ≤ 50 mio.)
		2 external valuators (real property value > 50 mio.)	2 external valuators (company value > 50 mio.)
		Basis: audited annual accounts/ inventory of assetsMethod: NAV-approach	Basis: audited annual accounts/ inventory of assetsMethod: normally DCF-approach; NAV-approach, if applicable
Subsequent valuation	Real estate company	1 auditor & 2 external valuators	Internal or external valuation possible

Publications by the German Federal Financial Supervisory Authority (BaFin) concerning the Terms and Conditions of Investment for Closed-ended AIFs: Cost Clause Templates Term Extensions, Requirements for Blind Pool Constructions

At the end of the year, BaFin published statements on various topics concerning the drafting of the terms and conditions of investment for closed-ended public AIFs. Since the German Capital Investment Code (KAGB) does not contain any specific requirements for these items, the announcements will have an important role in practice. The following article provides an overview of the three publications, each of which is available on BaFin's website (www.bafin.de).

1. Model Components of Cost Clauses for Closed-ended Public Investment Funds

BaFin's Model Components for Cost Clauses regarding Closed-ended Public Investment Funds (Musterbausteine für Kostenklauseln geschlossener Publikumsinvestmentvermögen), published on 30 September 2014, is intended to ensure uniform administrative practice and an efficient approval process for the investment terms and conditions. After months of intensive discussions the published version paved the way for reaching a final reconciliation between the German Federal Ministry of Finance, BaFin and the German trade associations (bsi and BVI). In comparison to the draft of 31 July 2014 which BaFin presented for consultation, many of the model draft clauses were made significantly less stringent and, from the trade associations' point of view, more practicable. Some of the points of the model components, which are especially relevant in practice, are briefly described below.

BaFin generally distinguishes between the following cost items:

1. Subscription price, issue premium, initial costs
2. Current expenses

- Current remuneration
- Expenses charged to the undertaking
- Transaction fees and transaction and investment costs
- Performance-based compensation
- Other costs to be paid by the investors

The **initial costs** include the one-off expenses and remuneration in connection with launching the fund and designing, establishing and marketing the undertaking. In its draft for consultations BaFin still **differentiated the expenses charged to the undertaking** on the basis of the date the fund was launched, i.e. the investor's first subscription. This date cannot, however, be determined at the time the terms and conditions of investment are prepared. Consequently, the differentiation was changed in favour of substantively distinguishing between the types of costs. Due to their nature, current expenses, such as initial operating expenses, are therefore not allocable to the initial costs, whereas specific marketing costs, such as for roadshows, are. In contrast to this, the distinction is still to be made according to the time-line in respect of the expenses for legal and tax advice; for these items, the date of the marketing authorisation is decisive.

In the future either only the average net asset value for the respective financial year or (alternatively) the sum of the undertaking's average net asset value and the payments made by the undertaking to the investors up to the respective cut-off date (but not exceeding the investors' subscribed limited partnership capital) may be used as the **assessment basis for the computation of the current remuneration**. The use of fixed remuneration assessed on the basis of the limited partnership capital, which was previously common in the industry, is no longer permissible. This rule is designed so that AIF capital management companies have a greater exposure to the risks of managing the assets and the general market developments. A minimum compensation in the form of a fixed monetary sum may be agreed only for a period of up to 36 months, starting from the launch of the fund. A maximum compensation fixed by reference to a specific sum is permissible.

Both bases for assessment may also be alternatively relied on for the computation of the **depositary's remuneration**. If the depositary agreement foresees a different computation method for the depositary's remuneration, the AIF capital management company bears the risk arising from the incongruence of the clauses because the rate stipulated in the terms and conditions of investment represents the maximum amount allowed. In addition to the depositary's remuneration, the reimbursement of expenses may only be foreseen in the context of necessary external expert acquisition valuations or external expert opinions for the verification of ownership.

Remuneration and costs, which are incurred at the level of a property undertaking do not need to be separately reported. It is sufficient if the prospectus contains a specific explanation of this. These costs impact the undertaking's net asset value and thus have an economic effect.

In contrast to the draft for consultation, the final version of the Model Components does not contain an exhaustive list of the expenses charged to the undertaking, but rather only sets out examples, which BaFin considers to be standard. Other or alternative expense items, which are not mentioned in the Model Components, are permissible, provided they are not less transparent or appropriate than the items mentioned and that the circumstances justifying the expenses are clearly distinguishable. On the other hand, costs incurred for the preparation of the investment decision, such as agency commissions for asset managers, are not permitted, since these form a part of the capital management company's obligation to manage the portfolio and are covered by the compensation for administration, nor is the reimbursement of expenses for the undertaking's bodies permitted.

The AIF capital management company may charge a transaction fee for the purchase or sale of assets. Furthermore, the taxes and fees arising in connection with the transaction may be charged to the undertaking as prescribed by law. The remaining costs charged by third parties are to be covered by the transaction fee. If no transaction fee is levied, the costs incurred from third parties may be invoiced as transaction costs instead.

Performance-based compensation (so-called performance fees) paid to the AIF capital management company is permissible in two constellations only: first, the determination may be made on the basis of a comparison of the value of the equities at the beginning of the reporting period to their value at the end of the reporting period (= term of the fund) taking into account any distributions already paid out. A cap based on the net asset value must be agreed. In this case, the settlement and the withdrawal are permissible only after all assets have been sold. Alternatively, performance-based compensation may be paid at the end of each financial year, if the investors have received payment in the amount of the investment they paid in (less the liable contribution) plus an average annual minimum interest, which is to be agreed (irrespective of the sale of the assets) at the time the performance-based compensation is invoiced. The AIF capital management company may also receive the performance-based compensation in the form of carried interest provided this is recognised for tax purposes; this will be relevant in particular for private equity funds. A performance-based compensation based on the performance of individual assets or "projects" in the funds is not permitted. Furthermore, performance-based compensation of advisors or similar third parties is not permissible; if such compensation has been agreed, this must be paid from the capital management company's compensation.

Other costs to be paid by the investor are those which are not charged to the fund, but rather are to be borne directly by the investor. In respect of these, the Model Components are not exhaustive. In this item, only those costs are to be listed which are to be paid by the investor above and beyond the general statutory provisions, such as costs for limited partners acting as trustees or proven expenses for the sale of shares on the secondary market. The prospectus must contain a notice of any notary and registration fees, account fees or other expenses when entering into and holding shares.

BaFin clarified that deviations not only in the wording, but also substantive deviations are permissible, provided they are not less transparent or appropriate than the standards set out in the Model Components. Even though certain latitude for individual drafting should thereby be retained, in practice the tendency will be for the issuers of funds to adhere almost word for word to the Model Components to avoid the time and cost consuming process of coordinating with BaFin on a case-by-case basis.

The terms and conditions of investment now also fix the framework for the AIF's maximum cost burdens for closed-ended funds (Sec. 266 (2) Sentence 1 in conjunction with Sec. 162 (2) No. 11 German Capital Investment Code (KAGB)). In respect thereof, BaFin relies on Sec. 26 (5) German Capital Investment Code (KAGB) to establish its authority to review the appropriateness of the costs; according to this provision the capital management company must have a suitable procedure to avoid infringing the investors' interests by charging costs, fees and practices which are disproportionate to the investment assets, taking into account the value of the investment assets and the investor structure. In contrast to this, fixing the amount of administrative compensation – as has been the case for open-ended public funds – is not deemed to be subject to supervisory review by BaFin.

As subsequently amending the terms and conditions of investment is only possible under the conditions set out in Sec. 267 (3) German Capital Investment Code (KAGB) (consent of at least two thirds of the investors), which is, in other words, hardly possible to achieve in practice, how they are drafted becomes even more important. It remains to be seen in how far issuers will be successful in developing alternative cost structures, which adequately take into account in particular the product and design-related special features and which are approved by BaFin.

2. Term Extensions in the Terms and Conditions of Investment for Closed-ended Public AIFs in the Legal Form of a Closed-ended Limited Partnership Investment Company (Investmentkommanditgesellschaft)

According to the criteria published on 4 November 2014 concerning the extension of terms in the terms and conditions of investment for closed-ended public AIFs, a basic term for the limited partnership investment company is to be stipulated in the terms and conditions of investment. If extension options are foreseen, these must also be specified, in respect of which the extended period may not exceed a maximum of up to 50% of the basic term and the basic term and extension(s) collectively may not exceed 30 years.

The possible reasons for an extension must be specifically mentioned in the terms and conditions of investment. BaFin has, for example, accepted the following as reasons for an extension of the term: "if a sale of the assets at a later time appears to be economically reasonable" or "the sales proceeds, which is likely to result from the sale of the asset, is below the value which was forecasted" or "when the term of a property undertaking (which was established for an indefinite term), in which the limited partnership investment company participates, has not expired by the time the basic term expires".

Furthermore, it should be noted that the public AIF's terms and conditions of investment must foresee a provision requiring the consent of the partners' meeting with at least a simple majority of the votes cast and, as a general rule, there may not be any rights of ordinary termination.

3. Catalogue of Criteria to Prevent Pure Blind Pool Constructions of Closed-ended Public AIFs

Since the investors in a closed-ended AIF generally make a long-term commitment, the legislator – as explained in the legislative history to Sec. 266 (2) German Capital Investment Code (KAGB) – wants to prevent blind pool constructions of closed-ended AIFs which do not foresee any restrictions whatsoever on the use of the investment resources. Sec. 266 (2) German Capital Investment Code (KAGB) therefore requires the capital management company to specifically state in the terms and conditions of investment which assets are to be created for the AIF and in what amount. In its catalogue of criteria published 6 November 2014, BaFin further refined this legal requirement. It is mandatory that the respective criteria be included in the terms and conditions of investment.

a. 60% Limit

At least 60% of the invested capital must be subject to fixed investment criteria. The remaining 40% may be invested without any further restrictions provided the assets are generally acquirable for the respective investment asset.

b. Substantive Criteria

In respect of substantive requirements, BaFin distinguishes according to the asset classes: real property, ships, aircraft, renewable energies and participations in undertakings. There are a number of binding criteria, which have been highlighted with model clauses, that must be taken into account in practice when selecting the relevant assets. Accordingly, it is obligatory to incorporate the criteria pertaining to the type of use, region and size category for the real property asset class. In addition, optional selection criteria which may be incorporated have been included.

c. Temporal Compliance with the Criteria

The investment criteria mentioned in the circular must be satisfied by the time the investment phase has been completed. This can generally take up to three years and is to be stated in the terms and conditions of investment. This period can be extended by a shareholders' resolution, adopted with a majority of 75% of the votes cast, by a further twelve months provided this is foreseen in the terms and conditions of investment.

For the capital management company (KVG) this means that, in addition to the statutory deadline stipulated in Sec. 262 (1) Sentence 3 for compliance with the principle of risk spreading and Sec. 263 (5) Sentence 1 German Capital Investment Code (KAGB) for compliance with the leverage and stress limits, which each run for a maximum of 18 months starting from the issuance, a further deadline for the investment phase as imposed by BaFin must now be observed.

d. Fund of Funds Constructions

The criteria are also applicable to fund of funds constructions with special purpose vehicles, in respect of which no pro-rata stipulation is required regarding whether investments will be made via the special purpose vehicle or whether investments will be made directly. In the case of so-called funds-in-funds constructions, BaFin clarifies that an assessment of the underlying assets of the respective target fund is not required. However, the umbrella fund (Dachfonds) must specify its investment criteria for the selection of the target funds for 60% of its invested capital.

Flat-rate Tax Pursuant to Sec. 6 German Investment Tax Act (InvStG) on Non-transparent Foreign Investment Funds Violates Free Movement of Capital

In its judgment of 9 October 2014 the European Court of Justice (ECJ) held that the German flat-rate tax on non-transparent investment funds within the meaning of Sec. 6 German Investment Tax Act (InvStG) violates the free movement of capital.

1. Factual Situation

Two Belgian nationals (plaintiffs) with unlimited tax liability in Germany held shares in foreign capitalisation investments funds in the period from 2004 to 2008 that did not comply with the disclosure duties pursuant to Sec. 5 German Investment Tax Act (so-called non-transparent investment funds). Consequently, the tax authority responsible for the audit assessed the income from the non-transparent funds on the basis of Sec. 6 German Investment Tax Act (InvStG), whereas, in the absence of disclosures pursuant to Sec. 5 German Investment Tax Act (InvStG), the plaintiffs declared the income from the shares themselves by way of an estimate or on the basis of receipts they received or publicly available information. The plaintiffs were of the view that the method employed by the tax authorities violates the principle of free movement of capital guaranteed by European law (Art. 63 of the Treaty on the Functioning of the European Union (TFEU)).

Sec. 6 German Investment Tax Act (InvStG) foresees that income from shares in investment funds shall be subject to a flat-rate tax penalty of 70% of the capital gains arising from the non-transparent fund within a calendar year, but not less than 6% of the last fixed redemption price in a calendar year, if the investment company does not comply with the reporting and disclosure requirements set forth in Sec. 5 German Investment Tax Act (InvStG).

The Fiscal Court (Finanzgericht) of Düsseldorf referred the question of whether the flat-rate tax pursuant to Sec. 6 German Investment Tax Act (InvStG) was consistent with European law to the ECJ by way of the preliminary ruling procedure. So far, the legal question at issue has led to differences in legal appraisals by different German fiscal courts.

2. The Judgment

In its judgment (C-326/12, van Caster and van Caster) the ECJ held that the existing German flat-rate tax within the meaning of Sec. 6 German Investment Tax Act (InvStG) violates European law as this constitutes an unjustifiable restriction on the free movement of capital.

Although the flat-rate tax generally is applied equally to non-transparent resident and foreign investment funds, the ECJ was of the view that the provisions led to an indirect discrimination against investors in non-transparent foreign investment funds.

The ECJ justified its view by reference to the fact that the reporting and disclosure obligations within the meaning of Sec. 5 German Investment Tax Act (InvStG) – in particular, the prescribed German language publication in the electronic federal gazette of official announcements (Bundesanzeiger) – will de facto scarcely be fulfilled by a foreign investment company, whereas a German investment fund will generally comply with these obligations. This results in de facto discrimination against investors in foreign investment funds. This discrimination cannot be justified by reference to the balanced allocation of the authority to impose taxes between Member States or by the need to ensure effective fiscal supervision, as the German tax authorities argued. The ECJ rejected these arguments because the taxpayer, who invested in these funds, would, in the end, be dependent on the conduct of the respective investment fund company and the German tax authorities had other means available to determine the tax base.

3. Practical Notes

In light of the opinion of the Advocate General, the ECJ's judgment was expected. The judgment essentially results in the non-applicability of the national provision (Sec. 6 German Investment Tax Act (InvStG) in respect of the taxation of German investors in foreign investment funds.

In response to this judgment, on 4 February 2015 the German Federal Ministry of Finance (BMF) published a statement in which it explained how to furnish evidence of the actual amount of income from a non-transparent investment fund until new statutory provisions are enacted.

According to this statement, a flat-rate mechanism for assessing the income from an investment fund does not have to be used in the context of taxpayer's assessment, if the taxpayer assesses the actual tax basis him- or herself and, furthermore, files documents or information which permit the actual amount of its investment income to be proven. The Federal Ministry of Finance expressly prohibits estimating the tax basis. It is important to note that the evidence does not have any effect whatsoever on the capital gains withholding tax where the shares are held in a German custody account, so that in this respect investment funds will continue to be deemed non-transparent and, when the assessment has led to excess amounts of capital gains taxes being withheld, these must be reimbursed.

In order to avoid the flat-rate tax, the taxpayer must file the so-called required disclosures before the tax assessment becomes final, which include in particular the amount of the dividends distributed and the income or equivalent distributed. For the purpose of verifying the tax bases, the tax authority may request in particular a so-called tax advisor's or auditor's certificate, in which the values were assessed according to the provisions of German tax law. Furthermore, other documents which permit a verification of the figures (prospectus, annual report, list of current totals and account balances and offsetting and reconciliation figures, which are relevant under investment law for determining the tax basis) may be considered. In contrast to the draft version of the above-mentioned statement from the Federal Ministry of Finance, the tax advisor's or auditor's certificate is no longer a mandatory minimum requirement. However, it can be expected that the financial authorities will, as a rule, request the presentation of the certificate or a determination of the tax base by a tax advisor or auditor. Furthermore, the final version of the statement no longer foresees the transmission of the proven tax base, as accepted by the tax authorities, to the German Federal Central Tax Office (Bundeszentralamt für Steuern) for the purpose of reviewing whether different tax bases were applied by other taxpayers for the same investment fund.

Furthermore, the taxpayer can provide additional information in order to benefit from so-called tax reducing circumstances (steuerentlastenden Tatsachen). This affects income which is in whole or in part tax free and which forms a part of the income or equivalent distributed as well as the possibility of crediting foreign taxes which were collected at the source. In this case, the tax authority may request further documentation, such as overviews of the dividends received and taxes withheld at the source itemised on a country-by-country basis along with the basis for assessing the amounts of foreign taxes which were withheld at the source and for which a credit is claimed, plus evidence of the basis of the apportionment in the context of the allocation of the expenses incurred for the generation of income.

According to the statement from the Federal Ministry of Finance, the taxpayer shall have the opportunity to prove the correct amount of the investment income before the expiry of the deadline of the assessment period and thereby avoid the flat tax. However, it should be noted that the tax administration has very high standards and the average investor will only rarely be able to provide the evidence required. As a rule, he will hardly be able to obtain the information and documentation required for proof from the investment fund company. Therefore, German investors in individual funds (special funds), who have the opportunity to request the required documents directly from the issuer, will in practice be the primary beneficiaries of the Federal Ministry of Finance's statement. Small investors, on the other hand, will often not be able to make use of this method, so that, in the end, it is questionable whether the administrative rule completely removes the restriction on the free movement of capital in all instances.

However, in those cases where an investment fund with German investors inadvertently fails to comply with the reporting and disclosure obligations, or only belatedly complies, the Federal Ministry of Finance's statement does offer the possibility of subsequent compliance or the determination of the tax base at a later date, even after expiry of the deadline, and puts this, as well as the submission of any information required, into the hands of the German investors. The rules set out in the Federal Ministry of Finance's statement dated 17 December 2013, according to which exceeding a deadline for disclosure by up to 10 calendar days was to be deemed harmless, have thus largely been rendered obsolete.

The ECJ's judgment will likely have importance for those EU member states beyond Germany, which also foresee flat-rate mechanisms for determining the tax base for investments funds where the disclosure obligations, the imposition of which was motivated by tax considerations, are not satisfied.

The Federal Ministry of Finance's Statement Concerning the Scope of Application of Sec. 18 German Investment Tax Act (InvStG) – Partnership Investment Companies (Personen-Investitionsgesellschaften)

In its statement dated 12 February 2015 the Federal Ministry of Finance clarified the scope of application of Sec. 18 German Investment Tax Act (investment partnerships): According to this, both German partnerships and comparable foreign undertakings fall within the scope of this provision. To distinguish these from corporate investment companies, a comparison of legal forms on the basis of tax criteria must be carried out.

According to the legislative intent, German investors in funds structured as partnerships (e.g. private equity funds and other Alternative Investment Funds or investment companies) should be taxed according to the tax principles generally applicable to partnerships.

In practice, the unclear wording of Sec. 18 German Investment Tax Act (InvStG), which was enacted as a part of the German AIFM Tax Harmonisation Act (AIFM-StAnpG), has led to uncertainty in respect of the differentiation from corporate investment companies (Kapital-Investitionsgesellschaften). According to this, partnership investment companies are those investment undertakings which, in terms of their legal form, have been established as a limited partnership investment company (Investmentkommanditgesellschaft) or a comparable legal form in the foreign jurisdiction. It was discussed in particular whether the criteria governing the supervision of limited partnership investment company pursuant to German law must be satisfied or whether a comparison of legal forms according to the differentiating criteria generally recognised under tax law should be applied.

If the undertaking is classified as a corporate investment company, then there is the risk that Sec. 19 German Investment Tax Act (InvStG) may be applied, with the result that the disadvantages pursuant to this provision applicable to business investors in respect of the taxation of equity instruments would apply.

1. Administrative order

In the statement letter, the Federal Ministry of Finance clarifies that Sec. 18 German Investment Tax Act (InvStG) is applicable to all investment companies that have the legal form of a partnership (e.g., GmbH & Co. KG) and to foreign legal entities with a comparable legal form. Thus, in the first place, the administrative authorities make a teleological extension going beyond the wording of the provision, which, for German domestic cases, would have applied only to limited partnership investment companies.

In the second place, since the German Reich Fiscal Court's so-called "Venezuela Judgment" (Reichsfinanzhof, RFH) (RFH judgment of 12 February 1930, VI A 899/27, RStBl. 1930, 444), the financial courts and administrative authorities have used the criteria applied to differentiate between partnerships and corporate entities to differentiate between partnership investment companies and corporate investment companiesas well. The financial authorities set out the most important criteria for the differentiation in the so-called "LLC Order" (Federal Ministry of Finance of 19 March 2004, BStBl. 2004, I, 411). These include inter alia the distribution of profits, management and representation of the undertaking, limitation of liability and the transferability of shares or interests. In the end, the overall picture of the relationships in the specific case is decisive.

2. Tax Compliance

In addition, the Federal Ministry of Finance clarified that the partnership investment company's managing director is responsible for complying with the obligations under tax law. These are governed exclusively by the provisions governing partnerships. The provisions governing supervision, which may have to be satisfied by a KVG, therefore do not result in derogation from the responsibilities under tax law.

Pursuant to the second sentence of Sec. 18 German Investment Tax Act (InvStG) the income of the foreign partnership investment company is to be separately and uniformly assessed in accordance with Sec. 180 (1) No. 2 German Fiscal Code (AO).

The Federal Ministry of Finance again explicitly points out that a separate and uniform assessment of the income from a foreign partnership investment company is to be made in Germany if at least two investors participating in the fund in question are liable to pay taxes on the income from these funds in Germany.

3. Conclusion

The Federal Ministry of Finance's clarification is to be welcomed because it removes the existing tax uncertainties. From a practical point of view, certain hybrid fund vehicles must still be differentiated, which, in a given case, is not always easy. Furthermore, German investors – but also foreign fund issuers – will not always know whether several investors, who are also subject to taxation in Germany, are participating in a fund.

Your contacts

For more information

Regulatory Advisory

Andreas Koch
Partner | Investment Management
Tel: +49 (0)89 29036 8739
akoch@deloitte.de

Stephan Mühlbauer
Director | Closed-ended funds
Tel: +49 (0)89 29036 8030
smuehlbauer@deloitte.de

Christof Stadter
Partner | Closed-ended funds
Tel: +49 (0)89 29036 8269
cstadter@deloitte.de

Annke von Tiling
Director | Investment Management
Tel: +49 (0)69 75695 6037
avontiling@deloitte.de

Tax

Alexander Wenzel
Partner | Financial Services Tax
Tel: +49 (0)69 75695 6111
alwenzel@deloitte.de

Thomas Vana
Director | Financial Services Tax
Tel: +49 (0)89 29036 8891
tvana@deloitte.de

Note

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