

FSI Investment Management Newsletter 1/2013 Current Regulatory Developments



Our current newsletter gives a review on selected aspects of the current status of the AIFMD implementation in Germany through the new Investment Act.¹

Overview status quo of the AIFMD implementation and time line

The national Draft Bill for implementing the AIFMD in Germany which comprises the new Investment Act (so called "Kapitalanlagegesetzbuch" or "KAGB-E"), was passed on 12th December 2012 by the federal cabinet and was handed on to further parliamentary legislative procedures subsequently. On 1st February 2013 the Bundesrat decided upon its change requests which will presumably only have a small impact on the Draft Act. The hearing in the finance committee is expected on 13th March 2013. The final version of the Act is to be expected in May or June 2013. Despite this, the Act is supposed to come into force on 22nd July 2013.

Furthermore, the European Commission published the final draft of the Level-2 regulation on 19th December 2012. It mainly sets

- exceptions of the scope of the AIFM-directive,
- organizational guidelines for asset management companies and depositaries, and
- provisions for transparency and supervision.

The draft of the Level-2 regulation (technical standards) on the distinction between mutual and closed-end AIF was in public consultation until 1st February 2013. In Germany, both regulations and the KAGB are supposed to be in force from 22nd July 2013 on.

¹ "Act in order to implement the directive 2011/61/EU on the administration of alternative investment funds (AIFMD-implementing Act)"; Article 1 Investment Company Act (KAGB)

Besides that, the European Securities and Markets Authority ESMA consulted future guidelines with the industry concerning the definition of AIFs until 1st February 2013. In addition, the ESMA remuneration guidelines for AIFM were published on February 11, 2013. Both guidelines will then be implemented in Germany through the BaFin administration and/or through separate national regulation(s) and/or decrees.

Transitional rules

The KAGB enters into force on 22nd July 2013. Hence, organizational requirements for asset management companies ("Kapitalverwaltungsgesellschaften" or "KVGGen" in the future) immediately apply to asset management companies, which also manage non-UCITS investment funds. According to our experience, we assume that the Federal Financial Supervisory Authority (BaFin) will follow the implementation with a "moderate approach" for the first months following July 2013.

The asset management company must apply for an AIFM-business licence by 22nd July 2014 at the latest. On the one side, investment conditions, charters or articles of incorporation of funds or closed-end investment vehicles already existing until 21st July 2013 will have to be changed until that date as well, but also organizational procedures to meet the KAGB-E requirements. On the other side, the compliance cut-off date might already be the date on which the business license or the terms and conditions for new funds will be filed after July 22, 2013.

Existing UCITS asset management companies or UCITS SICVAs do not need to apply for a new business license. The existing license remains valid in this respect. If such an asset management company was also requesting an AIFM business license to manage AIFs in the future, simplified approval procedures would apply and no re-filing of certain documents which are still valid today, would be necessary.

Various transitional rules apply to the different kinds of existing investment funds and closed-end fund launched before the cut-off-date (see par. 346 et seq. KAGB-E). Under these circumstances it is surely of importance that the process of redeeming shares of open real estate funds created before 21st July 2013, will follow the fund terms and conditions valid until that date, and that the new and even more restrictive KAGB-E conditions for redeeming real-estate fund shares (no threshold of 30,000 EUR for unit redemptions) would not apply in this respect.

Generally speaking, an existing asset company may launch UCITS or AIF on the basis of the new legal situation from 22nd July 2013 onwards. If the necessary KVG-licence has not yet been granted at that point of time, additional statements have to be made in prospectus, the KID or the investor information document. Once the license has been granted, these statements may be dropped. Overall, that provision will cause additional change burdens. This aspect should be considered in the product development.

Summary of the essential reforms due to the KAGB-E Draft Act compared to the previous Draft Bill and the published European Level-2 Regulation

Regarding content, the reforms basically concern the following topics:

1. Scope and exemptions from the KAGB-E or AIFMD
2. Regulatory classification of investors
3. Product-specific rules for mutual or special AIF
4. Provisions for real estate investment funds
5. Organizational requirements regarding asset management companies and referring in particular to delegation, own funds and risk management as well as regarding depository.

Scope of the KAGB-E and the AIFM directive and exemptions

The KAGB-E and the consulted ESMA standards or guidelines are based on a material investment fund term, which opens the scope the KAGB-E. This broad definition of an AIF, coming from the European AIF term, serves as a starting point. ESMA has developed further orientation criteria to facilitate the classification, see figure 1.

It is of importance that German companies which run a business strategy outside the financial sector will automatically not be classified as AIF. This ensures that the KAGB-E does not apply to numerous companies and corporations outside the financial sector. However, it is not yet clarified whether the KAGB-E e.g. applies to REITS. For several real estate firms it might still be difficult to distinguish between non-investment and investment activities. Even when taking into account the ESMA criteria, the situation will ultimately lead to a case-by-case decision in many cases. Such judgment should be based on an overall assessment of all given circumstances. The future BaFin administration practice may provide further points of guidance in this respect.

Figure 1*

Criteria for investment funds according to KAGB-E and AIFMD	ESMA – Criteria for collective investment undertakings
1 Collective investment undertaking	1 Collective investment undertaking
	<ul style="list-style-type: none"> • No ordinary company with a general commercial purpose • Raising capital with a view to generate a pooled return through the investment • No day-to-day discretion or control over the asset management by investors
2 Raising capital	2 Raising capital
	<ul style="list-style-type: none"> • Raising capital with a view to generate a pooled return • Commercial communication between the undertaking seeking capital and its prospective investors
3 Number of investors	3 Number of investors
	<ul style="list-style-type: none"> • No statutory limits by national laws, terms and conditions or similar to raise capital from more than one investor
4 Defined investment policy	4 Defined investment policy
	<ul style="list-style-type: none"> • Investment policy determined and fixed ex-ante and must be complied with by the undertaking • Investment Policy is part of the vehicles terms and condition and is defining material criteria for investments
5 Further criteria	5 Further criteria
<ul style="list-style-type: none"> • Investing for the benefit of the investors • No ordinary company with a general commercial purpose (explicit KAGB-E criterion) 	<ul style="list-style-type: none"> • No further explicit criteria defined • Overall assessment of all circumstances required however

* See Art. 1 Abs. 1 KAGB-E and. Art. 4 Abs. 1 AIFMD in connection with ESMA 2012/845 respectively.

Further exceptions from the scope of the KAGB-E apply to holding companies, securitization companies, group asset management companies as well as medium-sized firms under certain conditions, see figure 2.

The application of the KAGB-E exemption for holding companies may only be based upon an overall assessment of all circumstances. Assessment criteria are in particular the current business activities and the purpose of the business model.

The exception for group-AIF-asset managers triggers when firms do exclusively manage group assets without any external investor. This implies however that special funds launched by those asset managers would not take advantage of the tax and balance sheet benefits which German special funds usually have for their investors. It is still subject to discussion whether there should be an opt-in option for such managers in order to avoid besaid disadvantages. Alternatively, one could consider launching an investment fund with external investors in order to keep the above mentioned benefits.

The provisions for small special-AIF managers might be in favor of medium-sized firms like private-equity companies, but the concrete impact depends on the leverage structure at AIF-level.

However, medium-sized firms which run also a mutual fund business will certainly need to have a certain critical mass of assets under management ("AuM") in the future to cope with the numerous compliance provisions in a cost-efficient way.

Finally, the KAGB-E does not apply to closed-end investment vehicles fully placed and invested before July 21st, 2013.

Figure 2

Companies	AuM*				Impact
	≤ 100 Mio. EUR	> 100 Mio. EUR ≤ 500 Mio. EUR without Leverage	> 100 Mio. EUR ≤ 500 Mio. EUR with leverage	> 500 Mio. EUR	
Holding company	Out of scope				Exemption for all companies with a general commercial purpose
Group-internal asset manager	Out of scope				No launch of new special AIF, in particular special funds, possible
Special AIF manager	Registration only		In scope		Relevant for medium-sized firms, in particular PE fund managers or „European Venture Capital Fund“ managers
Mutual AIF asset manager	Selected provisions for organisation, depository, Valuation, Distribution	In scope			High market barrier for medium-sized managers

* Asset under Management: verwaltetes Vermögen je Fondsanbieter

Regulatory classification for investors

In future, there will be four regulatory classifications of investors, i.e. professional, semi-professional, private and qualified private investors.

The definition of a professional investor is taken from the MiFID. Professional and so-called semi-professional investors may invest in special AIF. "Semi-professional" investors are those who invest at least 200,000 EUR from an overall perspective and who have passed a corresponding suitability test run by the asset management company. The test results have to be documented appropriately and the asset manager has to provide evidence upon request. The category "semi-professional investor" intends to cover all former investors of special funds such as certain pension schemes (Versorgungskassen), church organizations or foundations which do not fulfill the criteria of a professional investor. Hence, a majority of those previous investors still have the possibility to invest in special funds in the future.

The asset manager internal remuneration system may in many cases provide for investments of bonus parts into AIF units or shares in the future. In such a case, any affected director or any other risk relevant employee would automatically qualify as semi-professional investor, without further documentation or evidence necessary.

Figure 3 summarizes the new regulatory investor categories.

Figure 3

Investor categories according to KAGB-E				
4 different regulatory categories for investors				
Classification	1	2	3	4
Category	Professional investor (PI)	Semi-professional investor (Semi-PI)	Qualified private investor	Private investor
Minimum investment	<ul style="list-style-type: none"> Not required for per se* PI 500,000 EUR for elective PI* 	<ul style="list-style-type: none"> 200,000 EUR (always required) 	<ul style="list-style-type: none"> 20,000 EUR (closed-end mutual-AIF) 100,000 EUR (EU-Venture Capital Funds) 	<ul style="list-style-type: none"> Not required
Further criteria	<ul style="list-style-type: none"> 2 qualitative criteria for elective PI** N.A. for per se PI 	<ul style="list-style-type: none"> Suitability test required 	<ul style="list-style-type: none"> Suitability test required 	<ul style="list-style-type: none"> N.A.
Suitability test	<ul style="list-style-type: none"> Only required for elective PI 	<ul style="list-style-type: none"> Always required except for relevant AIFM employees investing into special AIF 	<ul style="list-style-type: none"> Always required 	<ul style="list-style-type: none"> Only required if upgrade as PI or Semi-PI requested
Relevance	<ul style="list-style-type: none"> For special AIF 	<ul style="list-style-type: none"> For special AIF 	<ul style="list-style-type: none"> Closed-end mutual AIF (one-object mutual AIF) EU-Venture Capital Funds 	<ul style="list-style-type: none"> No investments into special AIF or one-object mutual AIF

* Classification according to Appendix II of MiFID 2004/39/EU. PI per se are banks, insurance companies, KVGs, investment or pension funds. It is also possible to become PI upon request („elective PI“) provided that certain requirements such as the minimum investment amount are met.

** at least one year professional experience or minimum 10 transactions of significant volume in the preceding 4 quarters. Either the minimum investment amount and one of these additional Criteria are met, or both criteria instead of the minimum investment amount.

In the institutional business, investors (either professional or semi-professional) should be categorized prior to their first investment by the asset management company. It is not yet clarified whether the classification has to be done again in case of subsequent investments (increases etc.) by the same investor or whether the suitability check needs to be updated on a more regular basis and independent of any investment activities. This is of major relevance for special AIF. Eventually, a risk-based approach appears to be reasonable.

If an investor meets the professional investor criteria, a corresponding classification seems to be advisable for an asset management company even though there might be an option to classify him as a semi-professional investor. The more restrictive suitability test and documentation requirements suggest this approach.

If an investor does neither fall into the professional nor the semi-professional category, he is automatically supposed to be a private investor, with the corresponding (limited) investment options. Existing portfolios might have to be switched accordingly, where necessary. In that case, special funds for instance might no longer be an option for churches, Versorgungswerke or foundations, which were classified as private investors. Where appropriate, a pooling through a legal vehicle for several investors might be an option in order to exceed the necessary minimum investment threshold amount.

The change requests coming from the Bundesrat (upper house of the German parliament) on 1st February 2013 are demanding some releases to the documentation requirements for semi-professional investors, but are simultaneously increasing the minimum investment amount up to 10 million EUR. We do not consider these proposals as particular helpful.

Private investors are all those who are neither classified as professional nor as semi-professional investors. Qualified private investors must invest an overall minimum amount of 20,000 EUR and pass the same suitability test like semi-professional investors. This investor category is of particular relevance for closed-end one-object funds to which the principle of spreading risk does not apply. For "European venture capital funds" and "sustainable investments" the minimum investment is equal to 100,000 EUR per investor. The corresponding European regulations have not been passed yet, however. For those funds, the same investor suitability tests mentioned before would apply.

Product-specific rules for mutual AIF or special AIF

Figure 4 shows the various types of domestic investment funds according to the KAGB-E

Figure 4

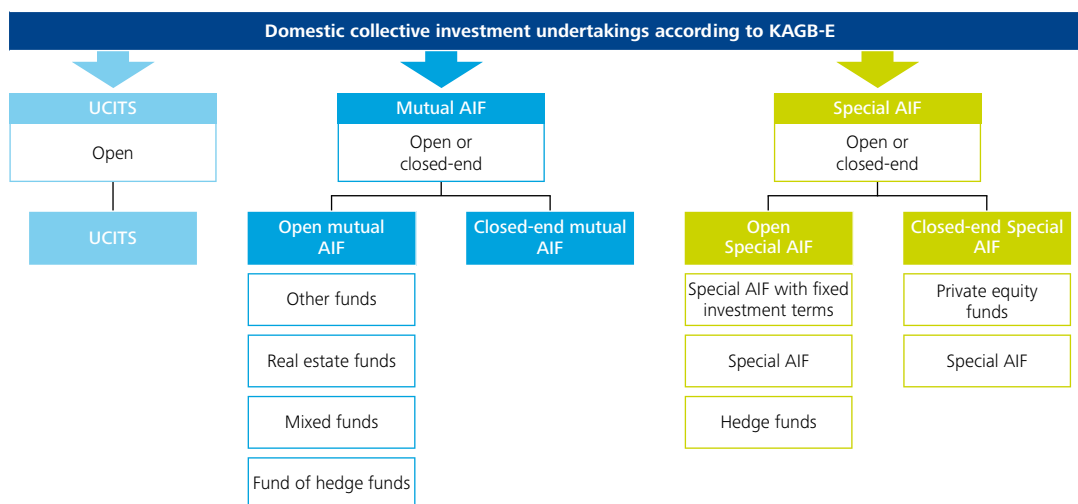
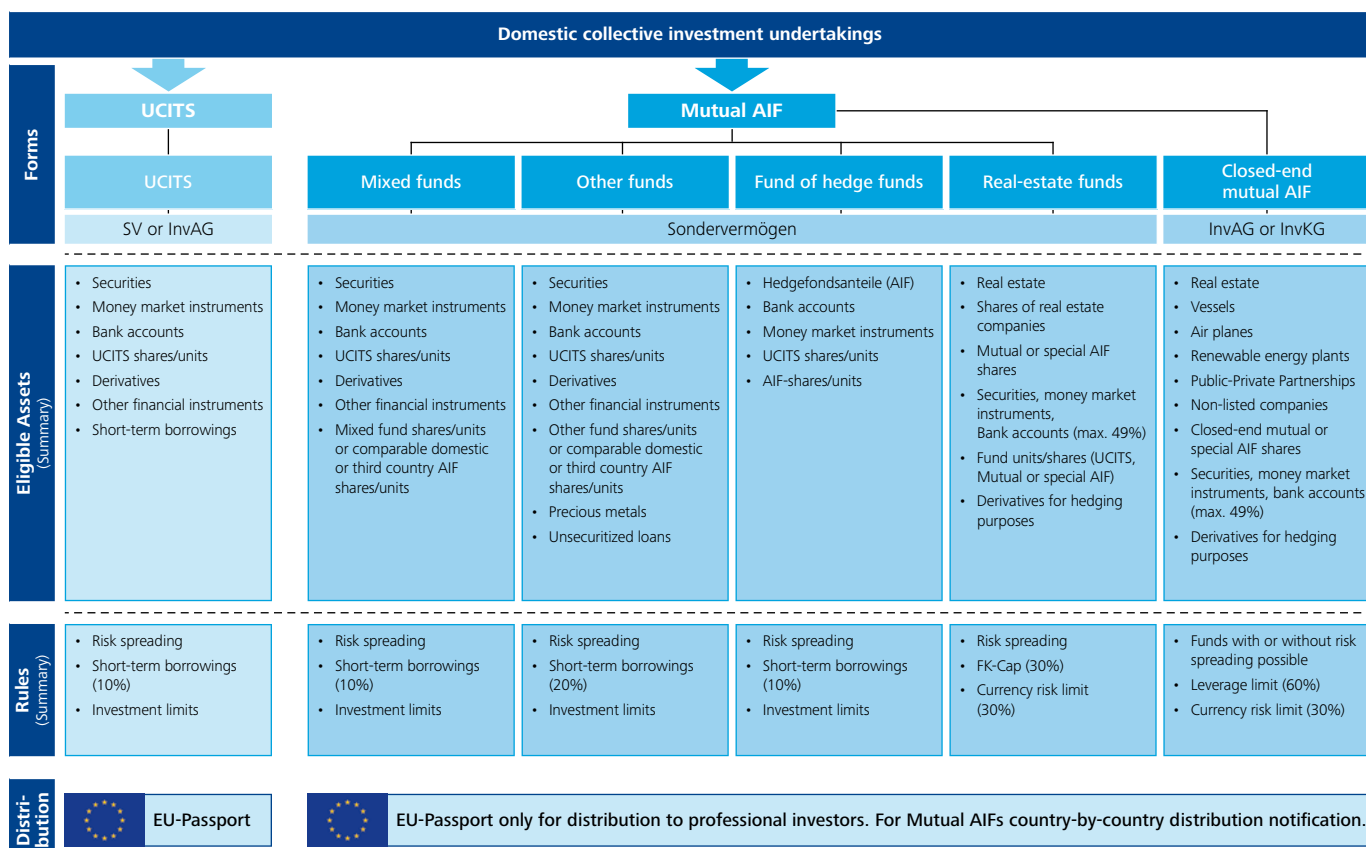


Figure 5 outlines the eligible asset universe for the different mutual funds in the future.

Figure 5



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Closed-end mutual AIF

Especially the possibility to invest directly into non-listed companies (private equity or venture capital firms) has been newly been introduced. The first Draft Bill provided only for such investments through fund of funds constructions.

The catalogue of eligible assets was expanded considerably and has now only indicative character.

The leverage ratio is capped at 60% of the net asset value of the fund instead of 30% planned insofar. The final number is still subject to further discussion in the ongoing legislation procedures.

However, the requirements for using derivatives (for hedging only) remain unchanged, together with the maximum limit for exchange rate risks of 30% of the funds' assets.

The principle of risk spreading is now explicitly defined for the first time. Therefore, funds are considered as being risk spread if they are invested in at least three assets comparable in size or volume or which, from an economic perspective, provide for a materially sufficient default probability risk spread through their usage structure. This definition may serve as guidance for existing and future product designs.

A deviation from this principle of risk spreading is possible for closed-end mutual AIFs. However, their shares may only be acquired by qualified private investors, professional or semi-professional investors (see above). Furthermore, the launching of such funds implies regulatory additional obligations. An asset management company has for instance to add additional information into the sales documentation.

As of today, we expect that the current BaFin administration approach re the principle of risk spreading for any other investment funds remains basically unchanged. Overall, the Draft Act is now establishing a significantly better framework for closed-end mutual fund managers compared to previous Draft Bill.

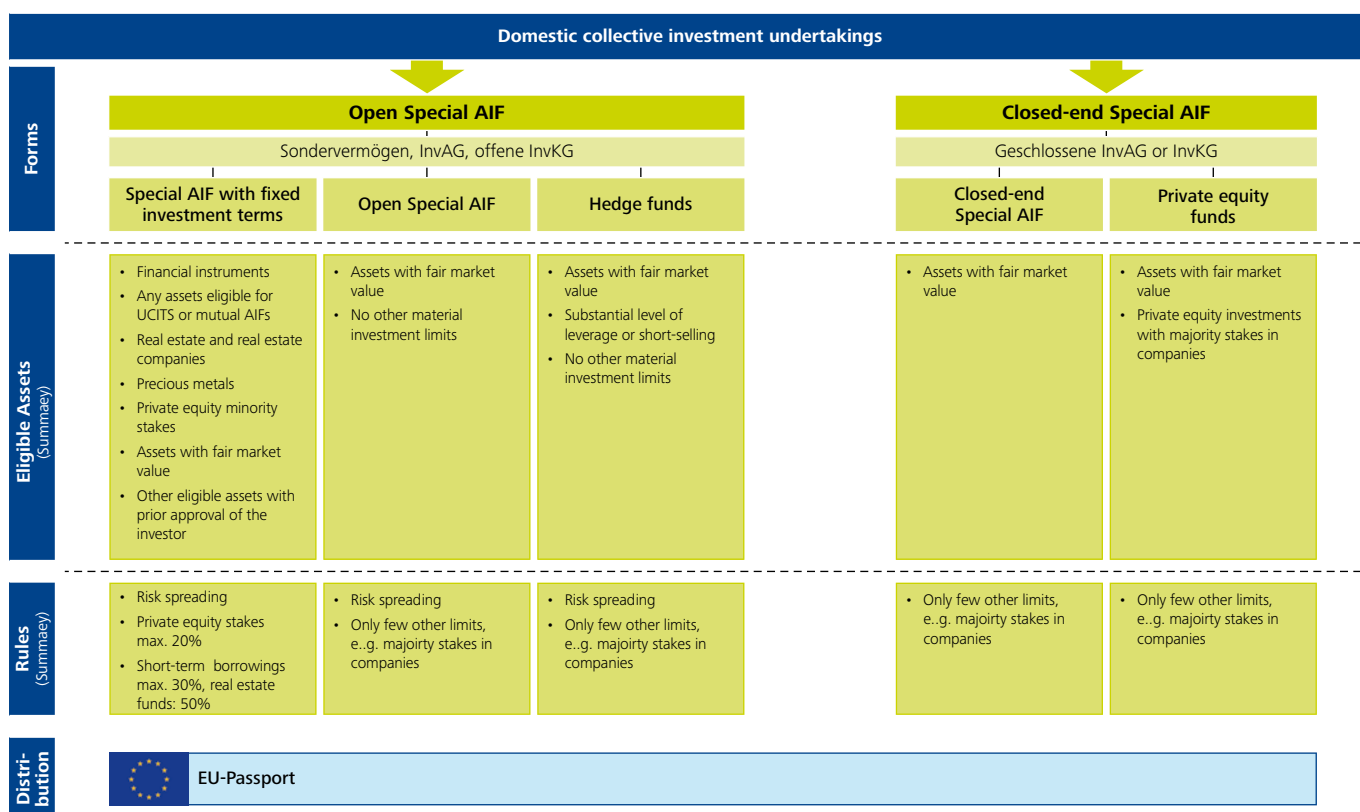
Special AIF

Special AIF are generally not subject to any material investment restrictions in terms of content. As general principle however, any asset must be valuable at fair market value. That reflects however only what is required already now. The provision set out in the previous Draft Bill according to which open Special AIF have to invest essentially into fungible financial instruments, was dropped. One-investor-fund constructions will be possible also in the future.

The former special fund ("Spezialfonds") becomes the so-called open special AIF with fixed terms of investment. The eligible asset catalogue is limited for those funds but the restrictions reflect the current Investment Act provisions. Only this kind of Special AIF will benefit from the privileged balance sheet treatment at investor level which is already applicable to Spezialfonds investors. There are no amendments to the previous Draft Bill in this respect. However, we refer to the conditions of a privileged tax treatment of special fund investors, which are no longer tied automatically to regulatory definitions (part 2 of this newsletter).

From an overall perspective, the current Draft Act is taking into account all major points from an institutional investor point of view. Figure 6 summarizes the classification and requirements for Special AIF according to the current status.

Figure 6



We currently assume the BaFin will continue to supervise special funds based upon a “moderate approach”. The AIFMD intends for instance to notify the distribution of special funds. In this context it is still subject to further clarifications if distribution notifications will also be required for existing special funds and how to deal with new investments into existing accounts by the investor in this respect. It might be the case that such re-investments would not trigger a new distribution notification to BaFin. Essential amendments to investment conditions imply a corresponding notification to BaFin as well; the term “essential” might however be interpreted business-friendly.

Requirements for real estate separate investment funds

The launch of real estate investment funds as mutual or special funds remains possible. Previously applicable provisions for those funds will largely continue to exist.

However, the AnsFuG provisions for share redemptions will be skipped for future mutual real estate funds, in particular the 30,000 EUR threshold for free redemptions. It is subject to further discussions whether the term “new investing investor” covers also re-investments into existing accounts. The minimum holding period of fund shares is generally 24 months. In addition, redeeming shares will only be possible once a year, and there has to be lock-in period of at least 12 months between the respective redemption dates. The minimum period between two subsequent subscription dates for new shares must be 3 months or longer.

De facto there are rarely any regulatory differences left compared to closed-end mutual AIFs, whose respective regulatory framework appears to be more favorable, see again figure 5.

In the future, professional and semi-professional investors may invest into real estate special funds just like other special AIF. The maximum leverage ratio remains capped at 50%, with 30% for any other Special AIF with fixed investment conditions. Nevertheless and just like for any other Special AIF a notification of the investment conditions (including any side-letter arrangements) to BaFin is required, as well as drafting and filing the AIF investor information and the distribution notifications. This implies significantly more administrative burdens for real estate fund managers in the future.

Regulatory requirements for organization and depository

We summarized hereinafter the most important topics.

Depository

Through the so-called Level-2 regulation, the European Commission defined on 19th December 2012, the various requirements for delegating functions of the AIFM to third parties. Furthermore, it pointed out that these requirements should not hinder the AIFM to act in the best interest of investors.

Considering the above, any parts of the value chain might in principle be delegated to third parties. Prerequisites are still to secure contractually adequate control-, instruction- and audit-rights and an appropriate outsourcing control-. The regulation is based on the assumption that the delegation leaves the ultimate responsibility of the asset manager unaltered. Requirements which go beyond what is currently already necessary are for instance:

- the justification of the outsourcing structure based upon objective arguments,
- the management of conflicts of interest of the parties involved (depository, investors, group membership),
- conditions for further sub-delegations
- the notification to BaFin of any outsourcing arrangement prior to its effective date , and
- a check if the delegation makes the AIFM to a letter-box entity or not.

The AIFM is considered as letter-box entity if it is not in a position to assume its overall responsibility given all other circumstances. A letter-box company may also be assumed if the investment management functions delegated to third parties substantially exceed the functions remaining within the asset manager. The criterion of “exceeding substantially” is barely selective and is not defined further. The overall structure of delegation as well as its importance for the AIFM is crucial to get a proper evaluation. Even though the term “essential” is no longer included in the regu-

lation, this term is however indirectly included through qualitative aspects in our point of view. It is also not yet clarified to what extent a group membership should be considered in the overall evaluation process.

Altogether documentation, evidence, analysis and administrative burdens increase sharply through the new provisions, and might well affect some management decisions regarding outsourcing in the future.

Risk controlling and additional own resources

The leverage must be calculated according to both the commitment approach as well as the qualified approach (i.e. without considering netting and hedging agreements). This point is of practical relevance for investment controlling functions, since it increases the administrative workload for risk controlling and the respective fund documentation. The use of the qualified approach is subject to further discussions at EU-level.

Furthermore and for the first time, explicit regulatory requirements for operative risk management shall apply, in particular for operational liability risks (so-called "professional liability risks"). Such risks may arise out of negligence regarding the fund management and administration responsibilities. Art. 12 of the Level-2 regulation comprises an indicative catalogue for potential professional liability risks, including misleading information in the sales documentation or investment limit breaches. Additionally, the Level-2 regulation sets up qualitative criteria for controlling, documenting (through a database) and reporting internally operational risks.

Professional liability risks must either be covered by appropriate additional own funds or through a corresponding insurance coverage. Own funds are considered as appropriate in this respect if they amount to minimum 0.01% of the AuM of the AIFM. This amount is furthermore subject to continuous adjustments in line with the corresponding AIFM's risk profile. If the insurance option is chosen instead, the insurance coverage must be equal to at least 0.7% of the AIFM's AuM for individual claims, or 0.9% of its AuM for all aggregate claims within one year. Further requirements are a minimum term of one year and 3 month cancellation period.

Depending on the insurance premium, the insurance option might indeed be an alternative to the additional own funds option.

Depository

The Bundesrat is requesting that only third party entities may act as depositories for AIFMs. The request is still subject to further discussion in the ongoing legislative process. If successful, the business model of group-own depositories would be at stake. Since the Bundesrat is however only in the position to eventually delay the Draft Act, but not to stop it, we consider this material amendment as rather unlikely to come into effect.

Appointment of a depository

AIFM may appoint either banks or MiFID firms as depositories, while UCITS managers may only appoint banks however. Furthermore, closed-end AIFs have the possibility to take certain trustees as depositories which are subject to professional registration and organization. This way is however only open for AIFs which remain closed for at least five years after its first investments, which do not substantially acquire securities or which acquire control of non-listed companies. The BaFin will lay down more detailed requirements for such professional depositories in a new circular in the months ahead.

Constraints for outsourcing by depositories

The KAGB-E set the provisions that UCITS and AIF depositories may only sub-delegate their depository tasks. With respect to other services provided so far, one need to distinguish between outsourcing and in-house service production. The KAGB control functions for depositories, for instance the performance of the investment limit checks, may not be delegated to third-parties anymore, but must be performed in-house instead. Nevertheless, receiving data supply to perform the controlling tasks will still be possible. The rather narrow definition of data supply according to the current Custodian Circular needs to be considered in this respect however. However, the outsourcing restrictions do not apply to other tasks, e.g. IT services or pricing services. In that context, KAGB-E is clarifying that securities delivery, settlement or payment systems will not fall within the KAGB-E outsourcing limitations.

AIFM business license procedure

BaFin declared in autumn 2012 that all major points regarding the AIFM business licence procedure will be addressed in an upcoming circular or FAQ. One item is the kind of knowledge and procedures which are required at AIFM director level for the various asset classes under management. Currently, BaFin distinguishes basically between real estate, securities and hedge funds.

We currently assume that the new categories of license requirements will not imply a greater level of detail compared to the current required standards.

The forthcoming circular or FAQ will probably comprise also further information about documentation which needs to be filed. Relevant topics are the required level of detail of the filing documentation (e.g. with respect to the risk management process or the investment strategies for funds) and the status of their completion necessary before starting the filing. The latter refers in particular to contracts which have to be presented, such as agreements on depositories or delegation contracts.

Given the current BaFin approach, we would be surprised if it set inappropriately high requirements on existing asset management companies. This has the background that in Germany, supervision does not only rely on documentation in which is filed upon request. It also relies upon the auditing financial statements, through which the auditor examines regulatory requirements. In that way, BaFin will have a continuous information flow on the implementation of requirements on a yearly basis which it has available to run its assessments.

The BaFin has installed a working group (AK KAGB) with associations directly affected by the AIFMD to discuss various aspects of the new regulation. Questions concerning the business license procedure are among the first agenda topics, but the group will deal also with items like the scope of application, fund approvals and distribution notifications.

Furthermore, the BaFin plans after consultation within the KAGB working group to issue new or amend existing regulations and circulars, such as the Derivative Decree, a circular or FAQ for the business license procedure as mentioned before, the Custodian circular, a decree for NAV errors (AntAnlVerlV) or minimum requirements for risk management of investment companies. The review of decrees like InvRBV and InvPrüfV, master templates for fund terms and conditions or the topic AIF-Trustee will be dealt within separate working groups however. We are represented in all working groups and bring in our industry know-how.

Finally, various contract templates are currently being discussed between the affected industry associations.

Tax-related consequences

The Government Draft for the AIFM-tax adaption law

Following the publication of the ministerial draft of a German Act on the adaption of the investment tax law and other tax laws to the AIFM implementing law (AIFM tax adaption law) on 4 December 2012, the German Government submitted its draft a revised draft (Government Draft) to the legislation process on 30 January 2013. As a consequence of the investments law's abolishment and the introduction of the new capital investment statute book (KAGB), the investment tax rules are adapted to the amended regulatory requirements. According to a grandfathering rule the current limited tax transparency taxation regime continues to apply for investment funds existing at the time the amended AIFM tax adaption law comes into effect (22 July 2013) if the investment fund continues to fulfill the currently applicable investment fund definition.

1. Scope of the investment taxation

According to the KAGB's categories, the draft for the investment tax law comprises European harmonized undertakings for collective investment in transferable securities (UCITS), alternative investments funds (AIF) and investment limited partnerships (Investment LP). Three tax regimes will be established:

- A slightly modified limited tax transparency regime applies to UCITS and those AIF, which meet the criteria of an Investment Fund (qualified AIF),
- As regards Investment Companies (in particular closed-ended funds) one distinguishes between the taxation for corporate-type and for partnership-type Investment Companies.
- For open-ended Investment LPs which i.a. fulfill the criteria for Investment Funds, a taxation regime applies corresponding to the limited tax transparency. Other Investment LPs are subject to the general rules for partnerships.

Certain entities (such as holding companies and securitization vehicles) are excluded from the scope of the Government Draft. Such entities remain subject to the general taxation rules for corporations or the rules of the German Act on Investment in Companies (Unternehmensbeteiligungsgesetz), respectively.

2. Investment Funds

Investment Funds within the meaning of the Government Draft are any UCITS or AIF which fulfill certain prerequisites. These prerequisites largely comply with the prerequisites of the investment taxation rules currently in force and their interpretation of the German Financial Supervisory Authority (BaFin).

In parts, the new definition displays considerable deviations from the current definition of an Investment Fund. In particular, as a new element, Investment Funds are subject to investment supervision as well as, at the same time, obliged to grant their investors a redemption right at least once per year. Further, with respect to the ministerial draft, the Government Draft clarifies that at least 90% of the investment value must be comprised of eligible assets.

The current limitations as regards investments in companies are restricted to investments in corporations. Investments in partnerships should thus not be possible anymore above the 10% threshold.

The Government Draft provides for additional investment limits. A maximum of 20% of the AIF's value may be invested in corporations that are not listed on a stock exchange or any other organized markets. Further, the investment in a corporation must be below 10% of the corporation's capital, contrary to the ministerial draft which had provided for a maximum threshold of 5%. Foregoing limitations do, however, not apply to real estate companies. According to the Government Draft AIFs that invest in real estate may hold up to 100% (contrary to 49% as provided for in the ministerial draft) of their investment as real estate participations.

As regards leverage, Investment Funds may generally only take up loans on a short-term basis and up to a maximum of 30% of their NAV. Based on the current BaFin interpretation, a short-term basis should correspond to a period of up to one year. Again, a special provision for real estate funds exists in that real estate funds may take out long-term loans of up to a maximum value of 50% of the real estate's market value.

For a qualification as investment fund, it is necessary that the Investment Fund's articles of association comprise all investment limitations.

The new, independent definition of the term "Investment Fund" (as well as the referenced definition of the terms "Investment Companies" and "Investment Partnerships") result in a separation as to the regulatory law –the uniformity of the Investment Act and the Investment Tax Act is abandoned in this respect.

3. Investment Companies (Investitionsgesellschaften)

In case the prerequisites for an Investment Fund are not met, an AIF is regarded as Investment Company for tax purposes. The taxation regime for Investment Companies basically follows the general rules for taxation of partnerships and corporations. In this respect, the provisions of the German controlled foreign companies (CFC) legislation shall remain applicable (sections 7 et seq. Foreign Tax Act).

The lump-sum taxation for domestic investors in investments in corporate-type, Investment Companies as provided for in the ministerial draft is no longer included in the Government Draft. However, distributions are taxable whereby one distinguishes between taxation for private and business investors. Private investors' dividends and capital gains are subject to withholding tax. For business investors distributions are fully taxable, especially the participation exemption does not apply.

For income and corporate income tax purposes, partnership-type, Investment Companies are treated as transparent. Domestic partnership-type Investment Companies are subject to trade tax.

4. Investment Partnerships

Open-ended investment limited partnerships ("Investment Partnerships") shall be introduced as third type of an open-ended investment scheme for regulatory purposes. The introduction of this investment schemes primarily serves the purpose to create a German based pension asset pooling vehicle for international companies.

Participations of foreign investors in German Investment Partnerships do not establish German permanent establishments. In order to qualify as Investment Partnerships, further conditions have to be fulfilled besides requirements for investment funds. For example, restrictions regarding the investment in non-listed participations, leverage and eligible assets as well as a limitation of 100 investors or partners in a one Investment Partnership apply.

Investors of qualifying Investment Partnerships (i.e. which fulfill the criteria of an Investment Fund) are subject to the taxation regime of limited tax transparency.

To the extent that an Investment Partnership does not fulfill the criteria of an Investment Fund, a transparent taxation applies according to the general rules for partnerships.

5. Transitional provisions

According to the Government Draft, investment funds within the meaning of sections 1 and 2 InvA still qualify as investment funds for tax purposes as long as they meet the prerequisites of the current regulations. Consequently, the respective rules for investment fund taxation are applicable to present and all future investors, as long as the funds are set up before 22 July 2013.

See [here](#) for further information regarding this subject.

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