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Current Regulatory Developments

The implementation of the AIFMD through the new Investment Act Draft Bill ("Kapitalanlagegesetzbuch" or "KAGB-E")[1]

The new KAGB-E creates a uniform regulatory framework for open- and closed-end funds in Germany. We summarized the most important consequences of the draft for open- and closed-end funds below.

1. New terms and definitions

The KAGB-E introduces a number of new terms and definitions. The most important of them are:

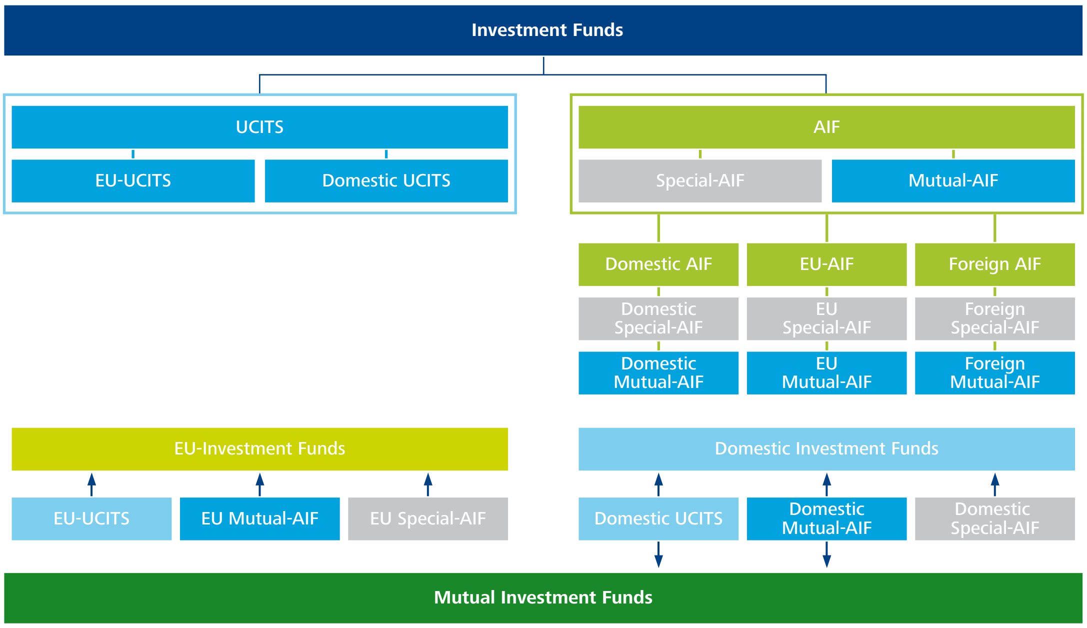
- **Investment Funds** ("Investmentvermögen (InvV)") are re-defined as collective investment vehicles, without the principle of risk spreading being a relevant part of the definition any longer;
- **Material definition of 'Investment Funds':** Investment Funds are either UCITS or AIF, other forms beyond those two main categories are not allowed;
- **Single-Investor-Funds** are still defined as Investment Funds, if the fund terms and conditions, the articles of association or the shareholder agreement do not limit the number of potential investors;
- **Open-end Investment Funds** are funds, which allow share or unit redemptions at least once within a 12 months period. Funds with longer redemption deadlines are categorized as **closed-end Investment Funds**;
- The term **professional investor** (as defined in the MiFID) becomes a central criterion for the different fund categories;
- **Mutual Investment Funds** are all funds which are open to private investors **(UCITS or Mutual-AIF)**. **Special-AIF** are for professional investors only;

[1] Full title: „Gesetz zur Umsetzung der Richtlinie 2011/61/EU über die Verwaltung alternative Investmentfonds (AIFM-Umsetzungsgesetz – AIFM-UmsG)", see Article 1 Investment Act Draft Bill

- **The term "Kapitalanlagegesellschaft (KAG)"** for management companies **is replaced by "Kapitalverwaltungsgesellschaften (KVGen)"**, either as AIFM ("**AIF-KVG**") or as UCITS management company ("**UCITS-KVG**");
- Management of an AIF means portfolio management or risk management for at least one AIF;
- **Financial portfolio management** ("Finanzportfolioverwaltung") is defined as management of third-party mandates; the term **individual portfolio management** ("individuelle Vermögensverwaltung") will cover only the management of non-financial instruments assets (i.e. in particular real estate or private equity investments, but not stocks, derivatives, or money market instruments) in the future;
- The fund terms and conditions (formerly "Allgemeine Vertragsbedingungen" and "Besondere Vertragsbedingungen") are now called **"Anlagebedingungen"**;
- **Distribution** now comprises every kind of offering, marketing or placement of investment shares. **Private-Placements** aren't defined as distribution. Fund sales to financial service firms, KVGen, other funds or insurance companies are no longer classified as private placements however;
- Only regulated banks and investment firms may act as **prime brokers**;
- **Carried interest** is now defined as a earnings-related management fee for AIF-management-companies.

Figure 1 shows the main regulatory fund categories according to the KAGB-E.

Figure 1 – Main regulatory categories for Investment Funds.

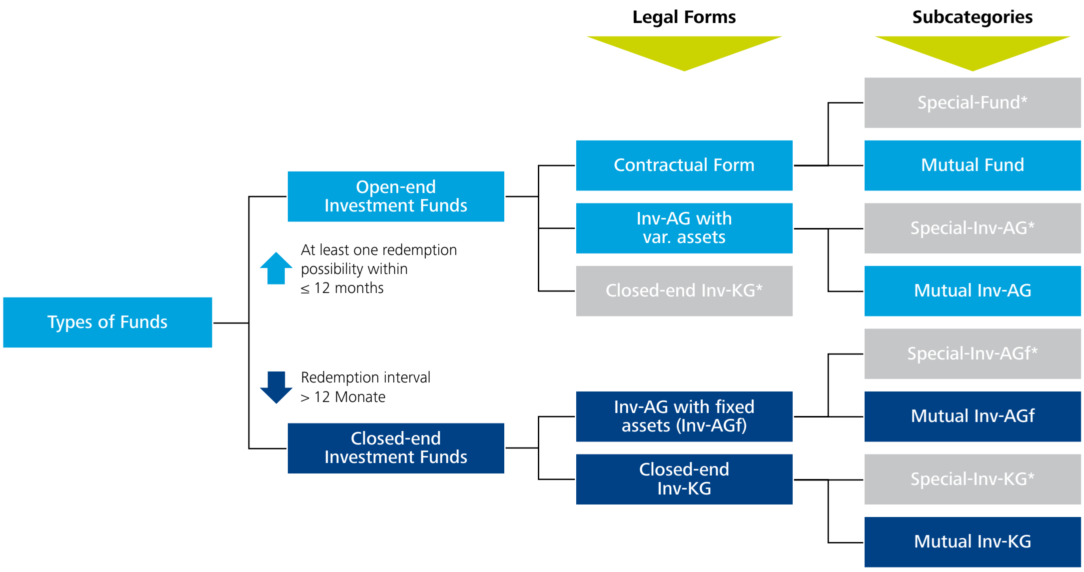


The KAGB-E allows three different kinds of Investment Funds:

- **"Sondervermögen"**, in contractual form,
- **"Investmentaktiengesellschaften (Inv-AG)"**, either with variable or fixed capital,
- **"Investment-Kommanditgesellschaften (Inv-KG)"**

Some types of these Investment Funds are for professional investors only, see Figure 2.

Figure 2 – Future potential legal forms for investment funds

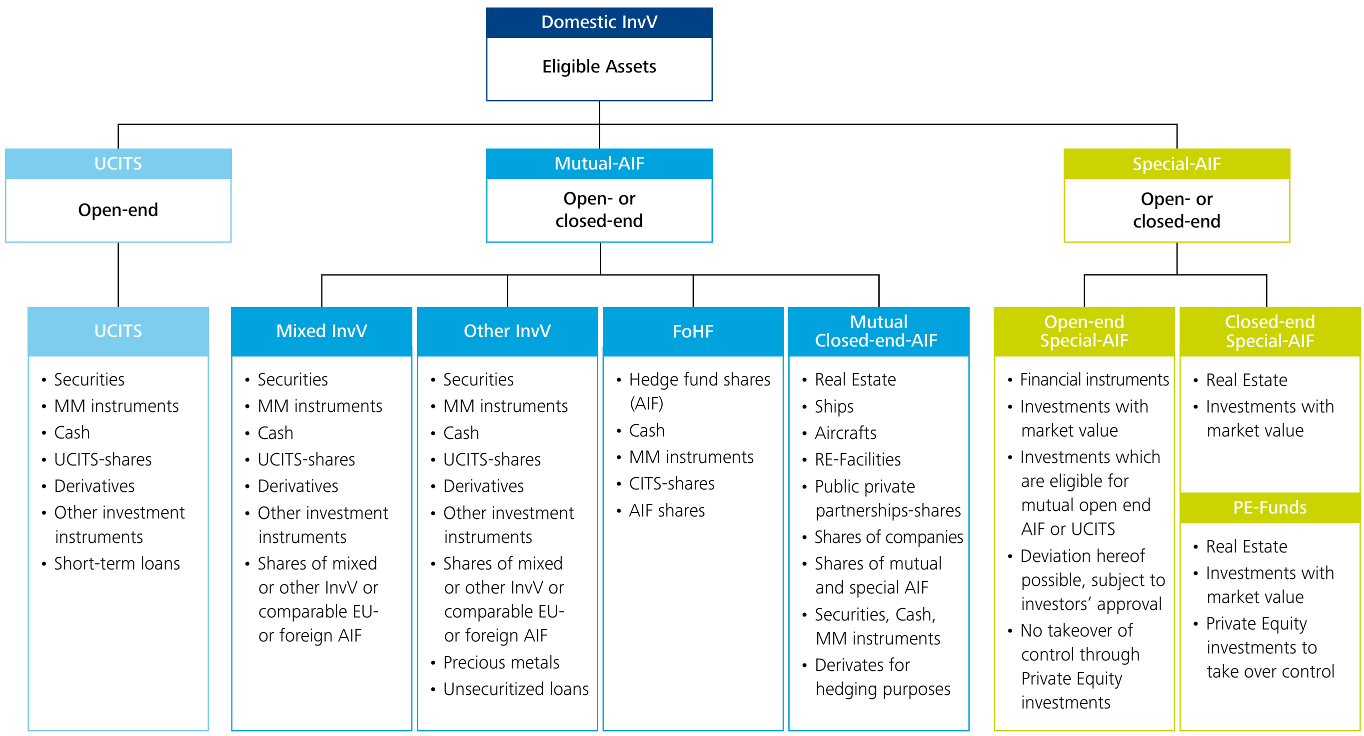


* For professional investors only, as defined in the MiFID.

2. Product-related regulations with respect to the different investment vehicles

The eligible assets for the different domestic Investment Funds are summarized in Figure 3.

Figure 3 – Eligible assets for Domestic Investment Funds



3. Gold plating

The Investment Act Draft Bill goes far beyond a mere 1:1 implementation of the AIFMD in certain areas ("gold plating"). We have summarized hereinafter the most relevant gold plating aspects:

AIF-Depositary

In contrast to the AIFMD provisions, the KAGB-E does only permit credit institutions, MiFID-firms and custodian banks to become AIF-depositories, but does not allow certified individuals like tax accountants, lawyers or notaries to take over the same role.

UCITS-Depositary

The Investment Act Draft Bill intends to implement already now some major provisions of the AIFM Directive for UCITS depositaries. This concerns in particular the requirements for sub-custodians and the regulatory framework for liability. The UCITS depositary may only outsource the sub-custody moving forward. Finally, the Draft states explicitly that custodian shall not re-use the assets of the UCITS for investments. A clarification of the term "re-use" in the upcoming legislative process appears to be appropriate.

Putting an end to mutual open-end real-estate funds

The AIFM Directive does not require to impose any restrictions for open-end Mutual-AIF to invest in real estate, as the current Investment Act Draft Bill does. It remains open if other EU member states intend to implement the same provisions. Luxembourg for example isn't expected to adopt similar restrictive requirements.

Categories for Special-AIF and the end of open-end real-estate funds for institutional investors

Beyond the AIFMD-requirements, the Draft Bill puts Special-AIF into two subcategories, i.e. open and closed-end Special-AIF and defines further provisions for their investment policy. This is intended to preserve favorable existing accounting and tax requirements. For professional investors tailored funds, future investments into real estate assets may only be done through closed-end Special-AIF structures, as it is the case with closed-end Mutual-AIF for private investors.

Exception for small AIFMs (so called "De Minimis Rule")

The Investment Act Draft Bill grants the AIFMD-business license exemption for small AIFMs only to AIFM setting-up Special-AIF. AIFMs acting as Mutual AIF-providers however are always required to get a BaFin-business license.

Outsourcing and Reporting

The KAGB-E is extending the AIFMD-minimum outsourcing standards beyond the current Investment Act and the UCITS outsourcing standards to all management companies (AIFM and UCITS). Those standards reflect however largely the current administrative BaFin-administration practice. Therefore, the additional implementation efforts for existing management companies (for instance the requirement to notify each outsourcing agreement prior to its effective date to the regulator) should be rather limited in our opinion.

Creation of funds up to the 22.07.2013 and grandfathering

Mutual and Special real-estate funds are allowed to be set-up under the existing regulatory provisions until the German Government approves the Investment Act Draft Bill during the upcoming legislative process (s. § 314 Abs. 1 and 2 KAGB-E).

Registration applications made for funds according to the previous German Investment Act expire by law, if they aren't approved by BaFin until 22/07/2013. This applies also for funds which have been approved prior to 22/07/2013, but have not been set-up until then (i.e. have not issued any shares).

A case of positive "gold-plating" are the grandfathering provisions in the Draft Bill according to which existing mutual or special real-estate Investment Funds may continue, if they have been created prior to 22/07/2013. This applies for instance to the so-called Mixed or Other Investment Funds. Nevertheless, they won't be considered as eligible target investments due to the newly imposed investment restrictions for open-end AIFs.

4. Surprising and crucial facts of the Draft Bill

Term 'management of AIF'

On the one hand, the term 'management of AIF' according to the AIFM-guideline is clearly defined as the provision of portfolio management or risk management. On the other hand, the KAGB-E states that the license of KVGen will be withdrawn by BaFin, if they don't provide portfolio management and risk management simultaneously. A further clarification during the legislative process appears to be appropriate to avoid potential misunderstandings in the future.

Transitional Provisions for licensing and fund applications

Basically, a KVG has time to apply for an AIFM-license until 22/07/2014. But the Investment Act Draft Bill requires that new AIF may only be set-up after 22/07/2013 if the AIFM has obtained its business license from BaFin. This provision reduces significantly the added value of the transitional provision. Management companies may therefore not set-up any new AIFs until obtaining their AIFM license.

The alignments of the fund terms and conditions to the KAGB-E provisions and the distribution notification for existing AIF (including special real-estate funds) may be delayed until 22/07/2014, but should not be done later than the AIFM-business license application at BaFin.

Valuation of assets and shares of a closed-end Mutual-AIF

Prior to any investment into real-estate assets, closed-end Mutual-AIF are required to obtain an external valuation report (initial valuation). An internal valuation is not sufficient according to the provisions of the KAGB-E. Furthermore, an additional external valuer has to value the assets and the shares of the fund (follow-up valuation) at least once a year. The guidelines should not apply to closed-end Special-AIF. This implies a significant tightening of the applicable regulations in comparison to the current situation.

Risk diversification for closed-end Mutual-AIF

The principle of risk spreading applies to closed-end Mutual-AIFs. According to existing BaFin administration practice on the scope of the (current) Investment Act, this rule implies an investment in more than three different assets.

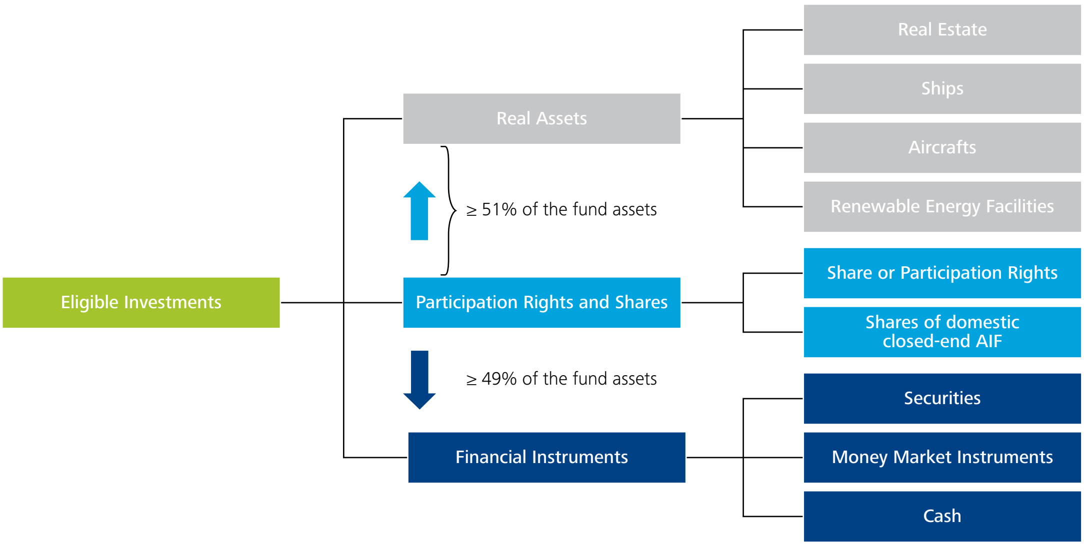
Single-Property-Funds do not have to be compliant with the risk diversification requirement, if its "semi-professional" investors invest at least EUR 50,000 in the fund. Single-Property-Funds with an investment of less than EUR 50,000 per investor are no longer permitted however.

List of eligible asset classes for closed-end Mutual-AIF:

The KAGB-E includes a list of asset classes in which closed-end Mutual-AIF are allowed to invest in (see Figure 4). Closed-end Special-AIFs are not subject to these restrictions in contrast. Since the list doesn't contain asset classes like life insurances, locomotives or container, the current Draft Bill would – if finalized in its current version – lead to a reduction of the available asset classes on the market.

Figure 4 shows the possible asset classes for closed-end Mutual-AIF

Figure 4 – Eligible assets for closed-end Mutual-AIF



Exposure to FX and Derivatives for closed-end Mutual-AIFs

The currency risk to a closed-end Mutual-AIF must not exceed 30 percent of its fund assets. The access for private investors to established markets such as North America or Australia through mere EUR investments will therefore become more difficult. Fund or fund units issued in a foreign currency are still possible. The 30% exposure limit would apply to any currency exposure of the fund which is different from the fund or the fund unit currency in this case however. Closed-end Mutual-AIF may only use derivatives for hedging purposes.

Limit for borrowing of closed-end Mutual-AIF

According to the regulations for open-end Mutual-AIF, borrowing for closed-end Mutual-AIF will be limited to 30 percent of the fund value. That implies a lower return on equity and a lower possibility of leverage, but also lowers the liquidity risk.

Special closed-end AIFs are allowed to take out unlimited short-term borrowing, but BaFin may impose limits on a case-by-case basis. The Draft Bill doesn't include any provisions concerning long-term borrowing through closed-end Special-AIF.

Insurances as investors of Investment Funds

An alignment of the investment restrictions applicable for insurance companies, as laid down in the German "Anlageverordung (AnlV)") and the BaFin Circular 4/2011, to the new Investment Act Draft Bill provisions appears to be appropriate in the short or medium-term. This would clarify the future eligible investments of insurance companies into Investment Funds.

5. Tax Implications

The Draft Bill itself doesn't contain any tax regulations. But it appears already inevitable that there will be amendments to existing tax regulations due of the forthcoming implementation of the KAGB-E.

In particular the substantial re-definition of the term" investment fund" in the Draft Bill will lead to an material adjustment of the currently used term "investment fund" for investment tax purposes.

It's still open at this very moment whether or not the regulatory and tax-related investment definitions will be further aligned in the future or be more separated in the context of a major investment tax reform.

Relevant future changes in upcoming tax regulation concerning the fund industry and their investors will be:

- Definition of transparent vs. non-transparent investment vehicles
- Tax treatment of the Investment-KG
- How will mergers of different legal forms be treated?
- How will a change of the legal form be treated?
- Tax regime for investment shares in the tax balance sheet of professional investors
- Future taxation of investment units or shares for private investors

We keep you informed about the developments through our Newsletter.

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