

Legal Update

Capital Investment Act

AIFM-Directive is implemented in Germany by the Capital Investment Act (KAGB) on 22 July 2013

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On May 16, 2013 the German Bundestag passed a law regarding the implementation of the AIFM-Directive (cf. our Legal Update „AIFM-Directive“ dated 4 July 2011), with the new “Kapitalanlagegesetzbuch” (KAGB, Capital Investment Act) as the essential and by far most comprehensive element. With more than 300 articles, this investment code regulates equally open-ended and closed-ended funds. In addition, numerous other laws have been adapted and repealed, respectively, in accordance with the implementation of the AIFM-Directive (e.g. Investment Act, Securities Trading Act, Trade and Industry Regulation Act).

Scope

The new KAGB provides for an extensive scope. In the future, every type of fund will be subject to a regulation by the KAGB in the future (so-called substantive fund concept).

Pursuant to the draft law, the business operations of a company which manages open-ended or closed-ended funds (capital management company), require a written

permission issued by the “Bundesanstalt für Finanzdienstleistungsaufsicht” (BaFin, Federal Financial Supervisory Authority). Capital management companies are undertakings whose operations aim at managing national investment assets, EU investment assets or foreign AIFs. Investment assets are a key concept of the KAGB. This means all collective investment undertakings which raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors.

Operating businesses outside the financial services sector do not form investment assets. Investment assets are either undertakings for collective investments in transferable securities (UCITS – previously regulated by the Investment Act as so-called directive-compliant special investment funds) or alternative investment funds (AIF – especially including non-regulated closed-ended funds). Already two investors are sufficient for the establishment of an investment fund. Therefore launch and management of all types of funds – including closed-ended funds – are subject to a regulation, with exceptions stated in a complete list (e.g. holding companies,

employee participation schemes). Since the definition of investment assets has beforehand already lead to numerous questions, the BaFin published an interpretation writing regarding the definition of investment assets. According to the BaFin, energy associations, for example, who run their power plants themselves, do not fall within the scope of the KAGB. The interpretation writing states a number of further exceptions.

Additionally, the “Investmentgesetz” (InvG, Investment Act) will be repealed by the AIFM implementation act, so that all funds launched in the future fall within the scope of the KAGB. The investment code which applies to closed-ended funds since 1 June 2012 still applies, but only to old cases.

Capital Management Company

Closed-ended funds, which have not been regulated so far, will in the future also have to be managed exclusively by capital management companies authorised by the BaFin.

The law distinguishes between UCITS capital management companies and AIF capital management companies, depending on the type of the managed funds. A capital management company may also receive an authorisation for both types of funds. The management can be implemented by an external or internal capital management company. An external management complies with the currently common model for closed-ended funds, where the initiator, or a company associated with the initiator, implements the management. If the fund is self-managing, the fund itself forms a (internal) capital management company. For the authorisation as an external capital management company, liquid initial capital in the amount of EUR 125,000 is, among other things, required. Internal capital management companies must have at least EUR 300,000 of liquid initial capital. During the term of its operations every external capital management company must hold own liq-

uid funds equivalent to the amount of at least a quarter of the expenses of the previous year. If the capital management company does not have a liability insurance, additional own funds in an adequate amount must be held. Assets belonging to the fund have to be kept safe by a depositary. This depositary generally is a custodian bank. Under certain conditions, auditors, tax accountants or lawyers may also form the depositary.

Types of Funds

The KAGB distinguishes between UCITS investment assets, closed-ended and open-ended investment assets. In case of open-ended investment assets, investors have at least once a year the right to return their shares or bonds. For closed-ended funds, this right to return or terminate only exists at the end of the fund duration.

The KAGB additionally distinguishes between the types of investors. Thus special funds and special AIFs may be subscribed to only by so-called professional or semi-professional investors. These include banks and pension funds as well as bigger companies, family offices and investors, who are investing at least EUR 200,000 and declare in writing that they are aware of the special risks of the investment. Public special funds and public AIFs on the other hand may be subscribed to by everyone.

Open-ended Investment Assets

Regarding open-ended investment assets, the Investment Act regulations have essentially been adopted. Thus open-ended investment assets continue to be possible as special funds of a capital management company (previously: capital investment company). In addition, such investment assets may be constituted as an investment stock company with variable capital or – if the group of investors is limited to professional or semi-professional investors – as an open-ended limited investment company.

Besides UCITS investment assets, only mixed investment assets and other investment funds, as well as funds of hedge funds and real estate investments are permitted as open-ended public investment assets. Mixed investment assets may only invest in stocks, money market instruments, investment certificates as well as derivatives, and may only participate in companies which invest accordingly. Open-ended investment assets may also, in the form of special funds, purchase real estate as well as shares in real estate companies.

Other investment funds may invest in a variety of enumeratively listed asset values, such as precious metals or unsecuritized loans. Other investment funds are prohibited from purchasing real estate or shares in real estate companies.

Open-ended special AIFs in the form of being marketed exclusively to professional or semi-professional investors may in principle invest in all asset values. Since the fund may possibly have to return shares, a quick liquidation method for the asset values has to be taken into consideration. Therefore, asset values will predominantly consist of financial instruments (e.g. stocks or other shares in companies, insofar as they are comparable to stocks or derivatives, options etc.). For open-ended special AIFs, the principle of risk spreading applies. Furthermore, open-ended special AIFs may not obtain control over non-listed companies. Therefore, private equity funds may only be constituted as closed-ended funds.

Closed-ended Investment Assets

The regulation of closed-ended funds implicates extensive provisions regarding corporate law. Closed-ended investment assets, for example, may in the future only be constituted as investment stock companies with fixed capital or as limited investment companies. Other formations such as that of a civil law company will therefore no longer be permitted for closed-ended funds.

The management of the fund company must consist of at least two individuals. A limited investment company must form an advisory board.

Closed-ended public AIFs

Regarding closed-ended public AIFs (closed-ended public funds), the KAGB provides for a large number of alterations.

For closed-ended public funds the Act contains a list of value assets in which investments are permitted. Other investments are not allowed. Permitted value assets are material assets, shares in PPP project companies, shares in non-listed companies, holdings of other closed-ended AIFs as well as securities, money market instruments and bank accounts. Material assets mean classic investments of closed-ended funds such as real estate, aircrafts, ships, renewable energies etc. The list of material assets available in the Act is not comprehensive. Investments of closed-ended public funds must in the future comply with the principle of risk spreading. This means that a fund may on principle only invest in at least three individual material assets, whereas the value of each material asset must approximately correspond. Alternatively, only one material asset may be invested in, if, from an economic perspective, the pattern of use guarantees a spread of default risk. This might be the case, for example, with investments in real estate if the property is rented out to many different tenants. So far common closed-ended funds, which purchase just one material asset, will in future be only permitted if the fund provides for a minimum investment in the amount of EUR 20,000 and the investor confirms in writing that he is aware of the special risks of his investment. Since the principle of risk spreading - particularly in the case of blind pool concepts - cannot be implemented from day one, the law allows the fund a period of 18 months to comply with this principle, beginning with the date of marketing start.

A closed-ended fund may from now on borrow capital only up to the amount of 60% of its value. Borrowed capital has to be raised on usual market terms. During the first 18 months after start of marketing, though, the 60% rate may be exceeded. It is unclear, however, which value will be relevant for the percentage assessment (market value or book value), and what the consequences are if this value decreases during the fund term. In order to reduce the borrowed capital ratio accordingly, the shareholders could grant the AIF further equity capital to avoid a prohibition of the business operations by the BaFin. However, there is no legal obligation to do this, which might lead to almost irresolvable difficulties. The observance of this 60% limit has to be proven to the BaFin. Debiting the material assets of the fund may also not exceed the percentage of the loan. Raising the loan must be market-based. The depositary is obliged to control the observance of these principles of loan.

Foreign currency funds will in the future be only permitted if the fund is introduced completely (and therefore also regarding the capital to be paid in by the subscribers) in the foreign currency. Otherwise, foreign currency risks may represent only 30% of the fund value.

Before purchasing value assets, the fund has to evaluate them by external valuers. If the asset to be acquired is worth less than EUR 50 million, one valuer is sufficient to perform this valuation process. If, on the other hand, the value exceeds EUR 50 million, two valuers, independent of one another, have to carry out the assessment. Each valuer has to value autonomously and without recourse to the assessment performed by the other valuer. The valuers are required by the law to inspect the object. Each valuer has to be named explicitly in the prospectus. After 3 years at the latest the capital management company has to exchange the external valuers. During the fund term the value assets have to be valued at least once a year. The annual valuation may, under certain conditions, be also performed by an inter-

nal valuer. In the future, closed-ended funds will also have to submit, along the articles of association, investment requirements for each fund, which describe and limit the investment strategy. Investment requirements have to be authorised by the BaFin. The Act allows the BaFin a term of four weeks for granting the authorisation. The requirements for investment may only be changed by a two-thirds majority resolution of the investors. The investors are allowed a period of three months to reach a decision. A change of investment requirements also demands an authorisation by the BaFin.

Essential investment information which has to be drafted in addition to the prospectus (currently known as "Vermögensanlagen-Informationsblatt", investment information sheet) must reveal the total costs of the respective fund with a cost ratio. This is supposed to ensure transparency in the normally complicated cost structure of a closed-ended fund.

Newly added will be a marketing authorisation, which has to be obtained from the BaFin before distributing the public fund to retail investors. This marketing authorisation replaces the previously required approval of the sales prospectus. The BaFin grants the authorisation within 20 working days after handing in the complete documents. Missing documents will be requested by the BaFin within a period of 20 working days. In the context of this marketing authorisation, the BaFin also examines the presented prospectus as previously. The Act does not provide details in this regard. Obtaining the authorisation for marketing and investment requirements may happen parallel. The authorisation for the investment requirements must, however, be present before the marketing authorisation is granted.

Closed-ended special AIFs

Closed-ended special AIFs, meaning AIFs whose shares may be held solely by professional and semi-professional investors, have a free choice of their capital assets. The only condition being that the market value of the purchased assets has to be determinable. Regarding the valuation, the same applies as to the public AIFs. For special AIFs the obligation to issue investment requirements, which have to be presented to the BaFin, also applies. The same is true for obtaining a marketing authorisation by the BaFin. Having to create a prospectus, as is the case with public AIFs, however, is not required. Nevertheless, the distribution regulations stipulate that the special AIF has an obligation to report to such an extent that the establishment of a prospectus-like private placement memorandum will be inevitable. Raising borrowed capital by the special AIF must be adequate, the adequacy must be presented and justified to the BaFin. A fixed limit does not exist, though. Debiting the assets of the special AIF must be market-based.

Prospectus Liability

The essential investment information is, just as the prospectus, subject to prospectus liability. New is the fact that next to the capital management company, the marketing will be subject to an own prospectus liability as well. This will result in marketing demanding a complete exemption. Regarding special AIF marketing, the documents that have to be provided to the professional and semi-professional investors (in other words, in practice: the private placement memorandum) are included in the legal liability.

Authorisation

Since 22 July 2013 the operation of a capital management company and therefore the launch of a fund within the scope of the KAGB are only permitted after the BaF-

in granted an authorisation. The applicant for an authorisation of an AIF capital management company has to be informed within three months after the submission of the complete application whether an authorisation will be granted. For UCITS capital management companies a period of six months applies. But as the competent authority, the BaFin has the possibility to extend that period by up to three months, if considered as necessary. Because of the expectedly large number of authorisation applications from July 2013 on, the BaFin is likely to make use of the period extension, so that the issuance of authorisation can be expected within six months.

However, the legal draft provides exceptions from the obligation to obtain an authorisation. If a capital management company manages solely special AIFs which in total (including loans taken out) do not exceed a volume of EUR 100 million, there is no authorisation obligation. The same applies if the capital management company only manages unleveraged special AIFs, whose total volume does not exceed EUR 500 million, and if the investors have no right to return their shares within the first five years after making the first investment. However, these capital management companies are obliged to register with the BaFin. Additionally, they have to comply with certain obligations to notify the BaFin.

The payment obligation for capital management companies which exclusively manage national closed-ended funds, and whose total volume including loans does not exceed EUR 100 million, also does not apply. However, these companies and their funds have to comply with the substantive KAGB regulations regarding closed-ended funds. Even these capital management companies have to register with the BaFin and have to comply with certain notification obligations. In addition to that, their prospectus has to contain a reference, emphasised in print that the capital management company is not authorised according to the KAGB and therefore is not

obliged to obtain certain requirements. This might constitute a marketing impediment.

The requirements for a registration application are very manageable. The BaFin has to confirm the registration to the capital management company within two weeks after receipt of the complete application. The BaFin may extend that period once for up to two more weeks. If the BaFin does not issue a statement within the first two-week period, the registration is deemed granted. The Act, however, stipulates that the capital management company has to prove the technical suitability and reliability of the directors. For some capital management companies, this may not be an easy hurdle.

One innovation, only now added to the regulation, determines that capital management companies, whose managed assets do not exceed EUR 5 million, and who have up to five investors, may register at the BaFin in a simplified procedure. This is supposed to simplify smaller funds which are based on personal attachment.

Another only now added innovation consists of the possibility that associations who manage assets up to the amount of EUR 100 million, may – subject to certain conditions - be launched as public AIFs and be managed by a merely registered internal capital management company. The aim is to simplify public participation models. However, this fact, added at the last minute, is likely to raise a number of questions in practice.

Transitional Provisions

Companies which are regarded as AIF capital management companies according to KAGB regulations, thus in particular companies which currently manage closed-ended funds, must submit an application for authorisation as a capital management company at the BaFin by 21 July 2014 at the latest. Between 22 July 2013 and 21 July 2014, the authorisation is deemed granted, so that

these companies may for the time being continue to constitute, market and manage funds. In case of constituting new funds the initiator has to assure that an authorisation application will be submitted in time. The lack of authorisation and consequences thereof also have to be highlighted clearly in the prospectus. If the application has been submitted by 21 July 2014, another transitional period until 21 January 2015 applies, while the authorisation is still deemed granted. However, the authorisation must be granted by 21 January 2015 at the latest. It should be noted that the other provisions of the KAGB already apply from 21 July 2013. For example, in case of newly constituted funds, investment requirements have to be drafted and applied for authorisation at the BaFin.

Companies which are exclusively managing closed-ended funds and who make no further investments after 21 July 2013 do not require an authorisation. They may continue managing these funds. To them, the old legal framework applies. The „infection risk“ contained in the preliminary KAGB drafts has been deleted from the law that has now been passed. A capital management company may now manage old and new funds at the same time, without having to adjust old funds to the new regulations.

Managers of closed-ended funds whose subscription period expired before 21 July 2011, and which have been launched for a term that expires by 22 July 2016 at the latest, also do not require an authorisation; these funds may make further investments even after 21 July 2013.

Funds that have been launched before 22 July 2013 but are supposed to be marketed from then on, have to be adapted according to the KAGB provisions. This means in particular that investment requirements for these funds have to be drafted and submitted for authorisation at the BaFin.

If an initiator would like to forego establishment and authorisation of a capital management company, one might consider if each fund company does not constitute an internal capital management company. In so far as the company falls below the abovementioned threshold, the fund would only have to apply for registration of the fund. An extensive application process for external capital management companies could thus be avoided.

Past capital investment companies, which in the future are considered as UCITS capital management companies according to the KAGB, have to adapt their special fund investment requirements to KAGB provisions within a year and a half. The KAGB authorisation to continue their business operations is deemed granted. As far as previous capital investment companies wish to continue launching funds as AIF capital management companies in the future, they also have to apply for authorisation.

Entry into Force

The KAGB entered into force on 22 July 2013. It is yet unclear when further legislative measures on European level (level 2 implementing measures) will be taken. Since the KAGB now exists in its final version, it is high time for issuers of closed-ended funds to address the topic and to develop individual strategies for the implementation of the various regulatory provisions.



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