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### INTERNATIONAL DEVELOPMENTS

## The German KAGB – A New Era for the Alternative Investment Industry?



BY MARCUS M. GEISS AND KATHARINA E. SAULICH

**T**he past few years have seen momentous changes in the rules and regulations that govern the investment industry in the Europe Union (EU) as a whole and Germany as one of its member states. The regulatory landscape has changed significantly at both levels. Certain other modifications to existing German legal codifications like the Securities Prospectus Act (*Wertpapierprospektgesetz*) in July 2012 and the introduc-

*Marcus M. Geiss is an associate attorney in the Munich office of Gibson, Dunn & Crutcher LLP and a member of the firm's International Corporate Transactions Group. He specializes in mergers and acquisitions and corporate transactions, as well as financing and investment law and regulatory matters. He also advises international clients on corporate insolvency issues.*

*Katharina E. Saulich is an associate attorney in the Munich office of Gibson, Dunn & Crutcher LLP and a member of the firm's Real Estate and International Corporate Transactions Practice Groups. She focuses on cross-border and domestic real estate transactions and investment law, with particular emphasis on real estate fund work and regulatory matters. She also advises clients on all aspects of commercial and corporate law.*

tion of a new Asset Investment Code (*Vermögensanlagegesetz*) in June 2012 notwithstanding, the main change has been the adoption of the new, so-called Capital Investment Act (*Kapitalanlagegesetzbuch – KAGB*)<sup>1</sup> in July 2013. The KAGB implements the European Union Directive on Alternative Investment Funds Managers (AIFMD)<sup>2</sup> into German law. The changes brought about by the AIFMD and its implementation into local German law have created a tightly knit network of regulation for many branches and products in the investment industry that were hitherto largely unregulated. The changes are far-reaching, and foreign based investors, investment advisors and other market participants, in particular, are well advised to familiarize themselves with the basics of the new system in Germany and, of course, other member states of the EU who also faced the obligation to implement the AIFMD into their respective local law.

The following article will highlight the key issues that a foreign-based alternative investment fund (AIF) and its manager (AIFM) will forthwith have to take into account in their strategic planning if they intend to mar-

<sup>1</sup> Gesetz zur Umsetzung der Richtlinie 2011/61/EU über die Verwalter alternativer Investmentfonds (AIFM-Umsetzungsgesetz – AIFM-UmsG), dated July 4, 2013, BGBl. 2013 Teil I Nr. 35, July 10, 2013, p. 1981 to 2164.

<sup>2</sup> Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, OJ 2011, L 174, p. 1 et seq.

ket new or existing non-German AIFs to German professional or retail investors from outside of Germany and/or outside of the EU and the European Economic Area (EEA). We will give an overview on the relevant provisions of the KAGB that apply to foreign-based AIFs and AIFMs, i.e. we will not deal in greater detail with the bulk of the KAGB which deals with German AIFMs and/or German AIFs. The outlook of our analysis will strive to be practical and pragmatic rather than strictly academic in nature. Bearing in mind that the KAGB is 183 pages long in the official parliamentary publication journal and contains 355 separate sections and articles (as opposed to the AIFMD's 73 articles), we will necessarily restrict ourselves to high-level comments and general pointers and tendencies that should hopefully allow the relevant circles to identify their respective individual areas of interest.

After a brief introduction to the historical background and intentions of the new legal regime, we will analyze the German approach to the implementation of the AIFMD, putting special emphasis on those areas where Germany has opted to create independent national solutions that may come as a surprise to a foreign investment expert who is already familiar with the AIFMD because they go beyond a mere one-to-one implementation of the AIFMD's mandatory minimum standards.<sup>3</sup> Since the AIFMD as the underlying EU legal framework has already been adopted in June 2011, a significant body of English language legal literature on the AIFMD has been published.<sup>4</sup> For the purposes of our overview, we assume that most AIFMs and other investment market players will be familiar with the AIFMD itself and the literature thereon.

After this introduction, we will briefly deal with the applicable German legal regime prior to the adoption of the AIFMD and the KAGB because: (a) this has been the status quo with which many investors are familiar; and (b) such historical background is a good platform from which to assess the impact of the changes introduced by the KAGB.

We will then analyze the key definitions and concepts of the KAGB that determine whether the law is applicable to a specific matter or not. In order to structure future AIFs, detailed knowledge of the scope of the KAGB but also potential exceptions or derogations will be very important for international market players.

Following this rather general look at the law, we will cover the new marketing (*Vertrieb*) regime and the regulatory requirements both on a personal level re-

<sup>3</sup> While we are only qualified to comment on German law, it is evident that the typical U.S. or U.K.-based AIFM who is looking to market non-EU or non-German AIFs into the EU will rarely have a German-centric point of view. On the contrary, it is likely that such an AIFM will always intend to market his products in a number of EU member states. When analyzing the new German legal landscape, we will therefore highlight German peculiarities, on the one hand, while, on the other hand, being mindful of a comparative perspective that all other EU member states also have had to adopt corresponding local laws to implement the AIFMD.

<sup>4</sup> *Schumacher/McNelley*, FINANCIER WORLDWIDE September 2013, p. 43 et seq.; *Bruen/Luff*, FINANCIER WORLDWIDE September 2013, p. 45 et seq.; also see *De Valera*, FINANCIER WORLDWIDE September 2013, p. 40 et seq. for a brief summary of the implementation of AIFMD in Ireland. *McGowan/Everit*, Business Law International, May 2013, 14 No. 2 Bus.L.Int'l, p. 105 et seq.

garding non-German-based AIFMs and at the product level regarding the respective non-German AIFs. Finally, we will briefly assess the grandfathering rules applicable to existing AIFs where marketing activities have already started and conclude with a short summary that lists selected key advice to be taken away from this overview of the KAGB.

## I. The German Approach to the Implementation of the AIFMD

One of the consequences of the financial crisis in Europe and world-wide has been a clear shift towards additional regulation. Especially, in the so-called "grey market", i.e. funds investing in alternative investment assets such as venture capital or private equity participations, single assets, real estate, ship or airplane funds but also hedge funds were largely unregulated in Germany and the EU. While many of these funds traditionally are not incorporated or managed from within Germany but rather by funds managers located in Great Britain,<sup>5</sup> it was nevertheless part of the public opinion in Germany that a lack of regulation of such funds and their managers had contributed to the financial crisis.<sup>6</sup>

As recitals 2 and 3 clearly highlight, the AIFMD itself was adopted by the EU institutions on June 8, 2011 in response to similar fundamental concerns.<sup>7</sup> As a directive, the AIFMD only provided a framework for national legislation but still needed further implementation by the various EU member states into their local laws. The deadline when each EU member state was obliged to implement the AIFMD into local law expired on July 22, 2013.<sup>8</sup>

**1. Faithful Transposition Versus Independent National Choices.** In theory, there would have been several ways of implementing the AIFMD.<sup>9</sup> One approach taken by several EU member states<sup>10</sup> was to opt for a faithful

<sup>5</sup> *Tollmann* in D/J/K/T, AIFM-RL, Einleitung, note. 25.

<sup>6</sup> *Hammen*, CORPORATE FINANCE law 3/2013, p. 135, 135 with further references.

<sup>7</sup> *Tollmann* in D/J/K/T, AIFM-RL, Einleitung, note. 16 with further references.

<sup>8</sup> Cf. Article 66(1) and (2) of the AIFMD. According to a currently still unpublished study by Ernst & Young and AIMA quoted at <http://cooconnect.com/news/mixed-progress-aifmd-transposition-across-eu-member-states>, as of July 22, 2013, just 12 countries (Czech Republic, Cyprus, Denmark, France, Germany, Ireland, Luxembourg, Malta, the Netherlands, Slovakia, Sweden, UK) have completed the full legislative implementation of the AIFMD. Six more member states have draft laws awaiting parliamentary approval (Austria, Bulgaria, Hungary, Italy, Latvia, Romania), while another five member states have made little or no progress towards drafting or finalizing the necessary legislation (Belgium, Finland, Portugal, Slovenia, Spain). Four countries (Estonia, Greece, Lithuania, Poland) have yet to issue clarification, the study added.

<sup>9</sup> *Buszalb/Unzicker*, BKR 2012, p. 309, 310 discuss the pros and cons of three potential methods of implementation that Germany could have chosen, i.e. separate statutes for UCITS and AIFs along the lines of the regulation model at the EU level, separate statutes for open-ended and closed-ended funds and an all-inclusive approach in one all-encompassing codification of German investment law.

<sup>10</sup> Luxembourg, for example, as one of the key European centers for the funds industry, has opted for such a faithful transposition, see *Wallach*, RdF 2013, p. 92, 92. On July 10, 2013, the Luxembourg Parliament adopted the law transposing

transposition of only the minimum requirements of the AIFMD into national law. The rationale behind this approach is that such a non-invasive, one-to-one implementation is said to maintain or maximize the attractiveness of a given jurisdiction as the market of choice for domestic and inbound investment. The fear of proponents of this approach was that any further reaching regulation might be seen as a potential competitive disadvantage when compared to other EU member states.

When the German lawmakers published the controversial first discussion draft of the KAGB on July 20, 2012,<sup>11</sup> it quickly became obvious that Germany had opted for an entirely different approach. Rather than merely implementing the requirements of the AIFMD, the KAGB is an all-encompassing codification of German investment law that expressly sets out to create a uniform high level of investor protection.<sup>12</sup> The KAGB replaces the Investment Act (*Investmentgesetz*) in its entirety and provides rules on both the substantive areas covered by the AIFMD and the earlier European directives on Undertakings for Collective Investment in Transferable Securities (UCITS),<sup>13</sup> which had previously been implemented in Germany by the Investment Act.

Even though the first draft of the KAGB was received with significant criticism<sup>14</sup> and was subsequently refined and partly revised in response to such criticism,<sup>15</sup> the overall approach has not changed. It is fair to say that by adopting the KAGB, Germany has chosen not to position itself in the market as one of the countries that aim to minimize administrative and regulatory burdens by sticking closely to the minimum standards set forth in the AIFMD. On the contrary, Germany has taken the AIFMD as an inspiration to create its own codification of investment law, which although respecting the framework set in the AIFMD, is not afraid to add independent and sometimes further reaching national rules.

the AIFMD into local Luxembourg law. The resulting law of July 12, 2013 relating to investment managers of alternative investment funds was published in the Memorial A N°119 on July 15, 2013 and is available online at [http://www.cssf.lu/fileadmin/files/Lois\\_reglements/Legislation/Lois/L\\_120713\\_GFIA.pdf](http://www.cssf.lu/fileadmin/files/Lois_reglements/Legislation/Lois/L_120713_GFIA.pdf). also see *Terblanche*, FINANCIER WORLDWIDE September 2013, p. 41 et seq. with an assessment of the implementation of the AIFMD in Luxembourg.

<sup>11</sup> Available online under: <http://gesetzgebung.beck.de/node/1022108>.

<sup>12</sup> *Niewerth/Rybarz*, WM 2013, p. 1954, 1956 making express reference to the justification and legal objectives provided in the parliamentary materials on the KAGB.

<sup>13</sup> Cf. EC Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, OJ 1985, L 375, p. 3 et seq., as amended inter alia by EU Directive 2009/65/EC of the European Parliament and of the Council of July 13, 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, OJ 2009, L 302, p. 32 et seq.

<sup>14</sup> *Jesch/Alten*, RdF 2013, p. 191, 192 with further references; *Voigt/Busse*, BKR 2013, p. 184 et seq.; *Görke/Ruhl*, RdF 2012, p. 289 et seq.

<sup>15</sup> Available online under: <http://gesetzgebung.beck.de/node/1022108>.

## 2. The Differences Between the KAGB and the AIFMD.

There are a number of areas where the KAGB deviates from the rules of the AIFMD that are worth highlighting to potential non-German AIFMs intending to market non-German AIFs to Germany-based investors:

- As already highlighted above, the KAGB provides a unified codification for both UCITS and AIFs, i.e. has a broader scope than the AIFMD. In the following, this article will focus exclusively on the rules adopted for AIFs and AIFMs and not discuss the regime for UCITS in the KAGB.

- The AIFMD exclusively contains provisions that deal with the AIFM.<sup>16</sup> The KAGB also contains additional national rules that deal with the AIFs themselves. The KAGB differentiates between various types of funds (closed-end vs. open end, special provisions for real estate funds or hedge funds et al.) and subjects them to individualized special rules.

- The KAGB has made use of the enabling clause in Article 43(1) of the AIFMD to deal also with the marketing of AIFs to retail investors<sup>17</sup> (or private investors<sup>18</sup> in the terminology of the KAGB). As far as such marketing to private investors is concerned, the KAGB has opted to impose stricter requirements than for marketing to professional investors as permitted by Article 43(2) of the AIFMD. For instance, the marketing of certain types of AIFs (like single hedge funds) to private investors is prohibited altogether or is dependent on certain minimum investments (e.g. for closed-end single asset funds a 20,000 euros (\$27,332) minimum investment).

- The AIFMD only knows two types of investors, the retail investor and the professional investor.<sup>19</sup> Unlike the AIFMD, the KAGB has introduced a third investor category, the so-called semi-professional investor.<sup>20</sup> The definition of professional investor<sup>21</sup> in both the AIFMD and the KAGB refers to Annex II to the Directive 2004/39/EC (Markets in Financial Instruments Directive). As far as the circle of retail investors pursuant to the AIFMD is concerned, the KAGB differentiates between semi-professional investors (as sophisticated retail investors who meet certain specifically listed criteria) and private investors. The level of protection for private investors is significantly further reaching than for the semi-professional investors.

- The KAGB introduces product specific rules in the area of Germany-based closed-end funds marketed to the public which have no equivalent in the AIFMD.<sup>22</sup>

<sup>16</sup> Cf. recital 10 of the AIFMD, OJ 2011, L 174, p. 2.

<sup>17</sup> See the definition of retail investor in Article 4(1) lit. (aj) AIFMD.

<sup>18</sup> See the definition of private investor in section 1(19) No. 31 KAGB.

<sup>19</sup> See the definition of professional investor in Article 4(1) lit (ag) AIFMD.

<sup>20</sup> See the definition of semi-professional investor in section 1(19) No. 33 KAGB.

<sup>21</sup> See the definition of professional investor in section 1(19) No. 32 KAGB.

<sup>22</sup> Examples would be the restrictions on permissible assets and investment thresholds in section 261 KAGB, the restriction on leveraged financing in section 263 as well as the requirements for the levels of risk diversifications in section 262 KAGB.



This approach has been criticized as over-reaching since it was not required by the AIFMD and is therefore unlikely to be mirrored in many other European jurisdictions—a fact that is said to result in a clear competitive disadvantage for Germany as an investment market.<sup>23</sup>

The key point for international AIFMs to take away from this would be that extra care must be taken whenever it is planned to market AIFs to the public in Germany and private or semi-professional investors are being approached. In those scenarios, special in-depth knowledge of German law is always required as the AIFMD itself does not provide an EU-wide, more or less uniform framework.

## II. The German Legal Landscape Prior to the KAGB

Prior to the entry into force of the KAGB, the AIFs themselves, their marketing and sale into Germany and the AIFMs were largely unregulated. AIFMs located either in the European Economic Community or other non-European Economic Community countries like the U.S. were relatively free to market and sell AIFs which often were incorporated in off-shore low-tax jurisdictions<sup>24</sup> like Guernsey or the Cayman Islands to sophisticated institutional or professional investors in Germany.

The main potential hurdle such foreign AIFMs needed to overcome in practice were the restrictions posed by various German statutes that linked the public offer of either securities or other types of investments or assets to prospectus publication duties. Such German statutes, like the Securities Prospectus Act or more recently the Asset Investment Code and the old Sales Prospectus Act (*Verkaufsprospektgesetz*) as its predecessor, provided for an obligation to prepare and publish a prospectus in Germany if certain requirements were met.<sup>25</sup> However, all of these statutes were based on European Union legislation and provided for exemptions and/or minimum thresholds of offerees<sup>26</sup> that were largely uniform across Europe. As a consequence, as long as the foreign AIFM carefully controlled the number of offerees to whom its AIFs were being marketed, an obligation to prepare and publish a prospectus in Germany could routinely be avoided.

This meant that AIFMs not based in Germany could build up and maintain good relations to a small group of carefully selected, hand-picked institutional or high net-value investors in Germany who they would contact

<sup>23</sup> Cf. Wallach, RdF 2013, p. 92, 103 who predicts that this may well result in a trend that AIF products aimed at the German market will be set up across the border in Luxembourg. Also critical of the overall approach and Germany's "gold plating" tendencies are Jesch/Alten, RdF 2013, p. 191, 193 with further references.

<sup>24</sup> See also Niewerth/Rybarz, WM 2013, p. 1154, 1155 with further references.

<sup>25</sup> Such prospectus publication obligations were contained in section 3(1) of the Securities Prospectus Act, section 8 f(1) of the old Sales Prospectus Act and section 6 of the Asset Investment Code.

<sup>26</sup> Exemptions were governed inter alia by sections 3(2) and 4(1) of the Securities Prospectus Act, section 8 f(2) of the old Sales Prospectus Act and section 2 of the Asset Investment Code.

with offer materials whenever they were collecting capital for one of their non-German AIFs. As long as such private placement activities did not qualify as a public offer and did not trigger prospectus publication duties, foreign AIFMs would not get into contact with any of the German regulatory authorities. Even at the level of legal advice, such marketing of AIFs could often be conducted with limited input from German counsel under the auspices of the AIFM's regular lead counsel in the U.S. or the U.K.

The introduction of the AIFMD, the KAGB and the respective other implementation laws in other EEC jurisdictions will obviously not signal the end of this business model or the good relationships with a select but limited collection of potential target investors in each member state. But they will certainly increase: (a) the administrative burden incumbent on both the non-German AIFM and the non-German AIFs marketed into Germany in the future; and (b) the need for corresponding in-depth and tailored local European legal advice and input. It seems clear that the era of largely unregulated private placement regimes will come to an end in the short or medium term in most member states if not all of the EU.

## III. Key Definitions and Concepts of the KAGB

**1. The Scope of Application, Section 1 of the KAGB.** When determining the scope of the KAGB, the key definitions are found in sections 1 and 2 of the KAGB.

### 1.1 The German term 'Investment Assets' versus the concept of AIF in the AIFMD

The key definition is found in section 1(1) of the KAGB and introduces the new German legal term of "investment assets" (*Investmentvermögen*). An English translation of the definition of investment assets in the KAGB would be:

Investment assets shall mean any organism for collective investment undertakings which raises 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 and which is not an enterprise engaged in operational activities outside of the financial sector. A number of investors within the meaning of sentence 1 shall exist if the investment conditions, articles of association or partnership agreement of such organism for collective investment undertakings do not limit the number of potential investors to one.

Even at first sight, most elements of this definition will initially strike a chord with international investors and lawyers who are familiar with the AIFMD as they mirror the definition of "AIFs" used in Article 4(1)(a) of the AIFMD.<sup>27</sup> However, while the wording is largely similar, this can easily be misleading for international readers. Even though the term investment assets is defined in almost the same words, it is broader than the term AIF at EU level. In line with the all-encompassing approach of the KAGB, Germany has not opted to

<sup>27</sup> The AIFMD definition reads 'AIFs' means collective investment undertakings, including investment compartment thereof, which (i) 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; and (ii) do not require authorisation pursuant to Article 5 of Directive 2009/65/EC.

implement the restriction in Article 4(1)(a)(ii) of the AIFMD into the definition of investment assets. As a consequence, the German term investment assets comprises of both an AIF (within the meaning of the AIFMD) and UCITS (as covered by the respective earlier European directives).

Within this broad concept of investment assets, section 1(2) of the KAGB then defines organisms that invest in UCITS as one sub-category of investment assets. AIFs, meanwhile, are a second subcategory defined in section 1(3) of the KAGB as “any investment assets, which are not UCITS.”

“Open investment assets” are either UCITS or AIFs where the investors or shareholders have the right to return their interests or shares at least once per year (section 1(4) of the KAGB). “Closed investment assets” are all AIFs that do not qualify as open investment assets.

Dogmatically speaking, the KAGB thus favors a so-called “material or substantive” definition of investment funds. The earlier Investment Act, on the other hand, which was replaced by the KAGB, followed a purely “formal funds definition” whereby only funds which expressly satisfied the requirements under the Investment Act were covered by the Investment Act—leaving a large number of German or foreign funds vehicles unregulated.<sup>28</sup>

This all-inclusive new material definition of investment assets contained in the KAGB means that: (a) there are no longer any unregulated collective funds vehicles, unless one of the express exceptions applies; and (b) the management of all investment assets definitely has to respect the requirements of the KAGB. Failure to do so may result in legal consequences ranging from regulatory sanctions via potential liability under civil law towards affected investors, on one end of the spectrum, to potential criminal liability, on the other end of the spectrum.<sup>29</sup>

## 1.2 Key Components of the Term Investment Assets for International Observers

When delving deeper into the various components of the German definition of “investment assets” and the guidance that exists, the following observations can be made:

### a) No National or Geographic Restriction

Quite significantly in the context of this article and its target audience of international investors, investment advisors and lawyers, the definition does not contain any restriction to national or Germany-based investment funds or vehicles. Once the requirements of the definition of investment assets are met, it does not matter whether such an organism is incorporated or set up outside of Germany.<sup>30</sup>

### b) Investment Business vs. Operational Entities

There is an additional clarification in the German law in excess of the underlying AIFMD definition that a collective investment organism that would otherwise be covered by the definition will be exempt if it engages in

operational business outside of the financial sector. The purpose of this clarification is to limit the reach of the AIFMD to a certain degree.<sup>31</sup> According to the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungen* – “BaFin”),<sup>32</sup> key examples covered by this exception for operational activities outside of the finance sector would include companies that raise capital in order to acquire real estate before operating a hotel or a hospital on such premises, project development activities, facility management, companies that produce goods or store raw materials or operate installations for renewable energy, ship charterers and the like.<sup>33</sup>

Especially in the context of private equity funds or venture capital funds, it remains to be seen how this restrictive clarification which tries to exempt operational entities, which might otherwise be covered, from the reach of the KAGB will be interpreted if such a fund heavily involves itself in the operational affairs of the portfolio entity.<sup>34</sup>

### c) Organism for Collective Investment Undertakings

The nature of the “organism for collective investment undertakings” is not defined any further in either the KAGB or the AIFMD. The European Securities and Markets Authority, however, puts key emphasis on the “pooling” of the capital raised.<sup>35</sup> BaFin adds that it is crucial whether pooled economic substance is created which is legally or economically separated (e.g. by way of a separate accounting circle). This would exempt most joint venture structures where capital usually is not separated in such a way.<sup>36</sup> The legal nature of the investment organism itself, on the other hand, is not decisive. This means that both corporations and private partnerships in all their legal forms are covered. Equally, the mechanism by which the investors participate is also not definitive. Corporate, contractual and other forms of memberships are all covered by the concept of collective investment undertakings.

The question of whether any given type of investment activity is then *permissible* in whichever organizational format chosen is an altogether separate issue that clearly needs to be separated from section 1(1) of the KAGB which merely defines the scope of the KAGB.

<sup>31</sup> See, for instance, Krause/Klebeck, RdF 2013, p. 4, 9. Cf. ESMA, Consultation Paper, Guidelines on key concepts of the AIFMD, dated December 19, 2012, Annex V, note 9 which uses the concept of an “ordinary company with general commercial purpose” in a similarly restrictive vein.

<sup>32</sup> BaFin guideline WA 41-Wp 2137-2013/0001, Auslegungsschreiben zum Anwendungsbereich des KAGB und zum Begriff “Investmentvermögen” dated June 14, 2013, section I.7; available online at <http://www.bafin.de>.

<sup>33</sup> See both Wallach, RdF 2013, p. 92, 93 and Wollenhaupt/Beck, DB 2013, p. 1950, 1952 with further references.

<sup>34</sup> Krause/Klebeck, RdF 2013, p. 4, 10 with interesting further analysis and drawing parallels to Swiss law where a similar distinction between operational business and collective capital investment activities has been in operation for several years as well as an assessment of typical film funds which engage in the creation of film licenses or new intellectual property – another activity that could easily be classified as “operational”.

<sup>35</sup> ESMA/2013/600, “Final report - Guidelines on key concepts of the AIFMD” dated May 24, 2013, Annex III – Guidelines on key concepts of the AIFMD, p. 29, available online under: [http://www.esma.europa.eu/system/files/2013-600\\_final\\_report\\_on\\_guidelines\\_on\\_key\\_concepts\\_of\\_the\\_aifmd\\_0.pdf](http://www.esma.europa.eu/system/files/2013-600_final_report_on_guidelines_on_key_concepts_of_the_aifmd_0.pdf).

<sup>36</sup> BaFin guideline WA 41-Wp 2137-2013/0001, section I.1.

<sup>28</sup> Krause/Klebeck, RdF 2013, p. 4, 5 provide an instructive historical overview on the legal developments and pros and cons of material vs. formal definitions of investment funds. Also see Wallach, RdF 2013, p. 92, 94; Wollenhaupt/Beck, DB 2013, p. 1950, 1950.

<sup>29</sup> Niewerth/Rybarz, WM 2013, p. 1154, 1156.

<sup>30</sup> Niewerth/Rybarz, WM 2013, p. 1154, 1157 with express reference to the parliamentary materials on the KAGB.

Further examples of activities that do not qualify as an “organism for collective investment undertakings” include parallel investments by several investors without organizational connections (e.g. certain types of “club deals”) as well as purely individual relationships like managed accounts.<sup>37</sup>

The “collective investment” aspect presupposes that the investors participate in the profits and losses which the portfolio assets generate. Investment instruments which involve either a fixed payment claim or an unconditional right to full capital redemption/repayment need to be differentiated here.<sup>38</sup>

*d) The Single Investor Exception*

Both the AIFMD and the KAGB demand that capital must be raised from a “number of investors,” but the definition of investment assets in the KAGB adds an explanatory second sentence which expressly states that single investor entities are not covered. This numerical restriction to no more than one investor has also been filled with additional life by BaFin. In its guidelines, BaFin has made it clear that the fact that only one investor is currently invested in investment assets does not *per se* rule out the application of the KAGB. The single investor exception only applies if the constitutional documents of the investment vehicle in question exclude the “theoretical possibility” of further investors.<sup>39</sup>

On the other hand, the classical general partner or managing limited partner of limited partnerships which are usually both owned by the founder of the fund vehicle do not qualify as “investors” if they are restricted to typical nominal investments only.<sup>40</sup>

If several investors invest via one trustee as the only formal investor, BaFin has stated that it will look beyond the legal trust or fiduciary construction and will not classify such structures as “single investor” entities.<sup>41</sup> This is in line with the position held by ESMA.<sup>42</sup>

*e) Raising Capital*

Both BaFin and ESMA demand that funds must be raised directly or indirectly for the account of an organism in a commercial manner to procure the transfer or commitment of capital.<sup>43</sup> In keeping with recital 7 of the AIFMD, classical family offices are usually not covered by the definition of investment assets because they constitute a pre-existing group of individuals that does not raise further capital from other investors in a commercial manner.

Using a similar argumentation, certain types of investment club deals do not fall within the realm of section 1(1) of the KAGB because they, too, concern pre-existing groups that abstain from commercial activities designed to obtain further club members.<sup>44</sup>

*f) Defined Policy for the Benefit of the Investors*

While the terms “defined policy for the benefit of the investors” may indeed still require further interpreta-

tion via practical precedents,<sup>45</sup> BaFin has provided some meaningful guidance already. A “defined policy” requires a set of non-discretionary criteria for the investment of the raised capital as opposed to a more general business strategy or the financing of general business activities which allow for greater flexibility and discretion.<sup>46</sup>

For the “benefit of the investors” is contrasted to scenarios where funds are invested for the benefit of the actual collective entity itself rather than its investors, members or shareholders.<sup>47</sup>

**1.3 Express Exceptions**

In line with the provisions of the AIFMD, the KAGB also acknowledges that there are several cases where the above definition of investment assets would be applicable, even though this is not deemed to be necessary or opportune. As a consequence, the KAGB includes special provisions expressly exempting certain scenarios from the applicability of the KAGB in its entirety or at least certain provisions thereof.

A detailed analysis of such exemptions would go beyond the scope of this article. Furthermore, their scope is largely similar in both the AIFMD and the KAGB. As such, they hold fewer surprises for international circles unfamiliar with the German implementation of the AIFMD. Purely by way of a non-exhaustive illustration, one could mention securitization special purpose entities,<sup>48</sup> employee participation schemes or employee savings schemes,<sup>49</sup> certain holding companies,<sup>50</sup> national, regional and local government bodies and other organizations which manage funds supporting social security and pension systems,<sup>51</sup> national central banks or other supranational banking institutions<sup>52</sup> already regulated in other statutes which are all exempted from the scope of both the AIFMD and the KAGB.

In terms of structuring a proposed AIF or other form of investment, a local advisor familiar with the intricacies of the various definitions above both at a national and the EU level will be an important asset because the multitude of national implementation laws will almost inevitably force an AIFM to take a multi-jurisdictional approach.

**2. The German Definition of AIFM and Management (Verwaltung).** In line with the requirements set forth in the AIFMD, each AIF is necessarily managed by only one managing entity. The KAGB, however, does not use the AIFMD’s terminology, i.e. the term AIFM is not featured in the KAGB.<sup>53</sup> Instead and in keeping with the KAGB’s broader scope, the defined term “management

<sup>45</sup> See *Wallach*, RdF 2013, p. 92, 93

<sup>46</sup> BaFin guideline WA 41-Wp 2137-2013/0001, section I.5; *Wollenhaupt/Beck*, DB 2013, p. 1950, 1951.

<sup>47</sup> BaFin guideline WA 41-Wp 2137-2013/0001, section I.6.

<sup>48</sup> Section 2(1) No. 7 of the KAGB which corresponds to Article 2(3). (g) of the AIFMD.

<sup>49</sup> Section 2(1) No. 6 of the KAGB which corresponds to Article 2(3). (f) of the AIFMD.

<sup>50</sup> Section 2(1) No. 1 of the KAGB which corresponds to Article 2(3). (a) of the AIFMD.

<sup>51</sup> Section 2(1) No. 5 of the KAGB which corresponds to Article 2(3). (e) of the AIFMD.

<sup>52</sup> Section 2(1) No. 3 and 4 of the KAGB which correspond to Article 2(3). (c) and (d) of the AIFMD.

<sup>53</sup> While the following section will use English translations of the actual German nomenclature, the rest of this article has and will continue to use the term AIFM because it is a term international investors and readers are familiar with.

<sup>37</sup> *Wallach*, RdF 2013, p. 92, 93.

<sup>38</sup> *Wallach*, RdF 2013, p. 92, 93; see also BaFin guideline WA 41-Wp 2137-2013/0001, section I.2.

<sup>39</sup> BaFin guideline WA 41-Wp 2137-2013/0001, section I.4.

<sup>40</sup> BaFin guideline WA 41-Wp 2137-2013/0001, section I.4.

<sup>41</sup> *Wollenhaupt/Beck*, DB 2013, p. 1950, 1951; BaFin guideline WA 41-Wp 2137-2013/0001, section I.4.

<sup>42</sup> ESMA/2013/600, dated May 24, 2013, Annex III, p. 32, note 19.

<sup>43</sup> BaFin guideline WA 41-Wp 2137-2013/0001, section I.3; ESMA/2013/600, dated May 24, 2013, Annex III, p. 32, note 13.

<sup>44</sup> Cf. *Wollenhaupt/Beck*, DB 2013, p. 1950, 1951.



entities” (*Verwaltungsgesellschaften*) in section 1(14) of the KAGB covers, on the one hand, “UCITS management entities” (*OGAW-Verwaltungsgesellschaften*) and, on the other hand, “AIF management entities” (*AIF-Verwaltungsgesellschaften*) which in turn are divided into three regional sub-categories.

Those subcategories are: (i) German “AIF capital management entities” (*AIF-Kapitalverwaltungsgesellschaften*) (“German AIFM”) defined in section 1(16) of the KAGB; (ii) “EU management entities” (*EU-Verwaltungsgesellschaften*) (“EU AIFM”) defined in section 1(17) of the KAGB; and (iii) “Foreign AIF management entities” (*Ausländische AIF-Verwaltungsgesellschaften*) (“Non-EU AIFM”) defined in section 1(18) of the KAGB.

Irrespective of the issue of the geographical origin of the management entities (Germany, another EU member state or a third country), the common feature of all these sub-categories is the term “to manage” (*verwalten*) as stipulated expressly in the respective definition in both the AIFMD and the KAGB.<sup>54</sup> While the KAGB merely refers to the AIFMD for the definition of EU AIFMs and Non-EU AIFMs, the German AIFM concept is defined in the KAGB itself. In both the KAGB and the AIFMD the term “to manage” requires that at least the portfolio management or the risk management is performed for one or more investment assets. Management is deemed to exist already if a capital management entity performs only one of the two listed activities (i.e. either portfolio management or risk management).<sup>55</sup>

International AIFMs should keep in mind the following guidelines when dealing with their often complex AIF structures that involve a multitude of contractual or corporate investment advisors, limited partners, managers or other involved entities. First, it is important to note that the KAGB will always define and identify the position of the “managing” entity based on functional criteria and the spirit of the underlying legal documentation, not based on the terminology used by the AIFs and their AIFMs. Secondly, portfolio management and risk management should regularly be performed by the same entity in the structure.

### 3. The Definition of Marketing (*Vertrieb*), Section 293 of the KAGB.

#### 3.1 Quo Vadis Private Placement?

One of the marquee changes often highlighted in the context of the introduction of the KAGB has been the discontinuation of the so-called private placement regime.<sup>56</sup> The KAGB effects this change in a rather low-key, indirect manner. Section 293(1) of the KAGB contains the basic definition of marketing (*Vertrieb*) applicable in the new law. Marketing is defined as the “direct or indirect offering or placement of interests or shares in investment assets.” The fact that this definition does not refer to or maintain the differentiation between a “public” offer versus a “private” placement implicitly means that a “privileged” private placement regime no longer exists.

<sup>54</sup> See Article 4(b), (w), annex I, section 1 of the AIFMD and section 17(1) sentence 2 of the KAGB.

<sup>55</sup> See *Jesch/Alten*, RdF 2013, p. 191, 193 with express reference to the parliamentary materials on the KAGB.

<sup>56</sup> Cf. *Wollenhaupt/Beck*, DB 2013, p. 1950, 1957; *Wallach*, RdF 2013, p. 92, 100; *Löff/Klebeck*, BKR 2012, p. 353, 354; *Weiser/Jang*, BB 2011, p. 1219, 1224.

At least in some constellations, however, this clear-cut change of direction triggered by the definition of marketing will only be introduced in a staged manner due to the grandfathering rules in the KAGB which are discussed in greater detail below.

#### 3.2 The Reverse Solicitation Exemption

By way of further clarification, section 293(1) sentence 3 of the KAGB expressly adds that marketing to either professional investors or semi-professional investors will only be deemed to exist if such marketing occurs “at the initiative of the management entity (*Verwaltungsgesellschaft*) or at its request”. This means that so-called reverse solicitation scenarios, i.e. situations where a professional or semi-professional investor contacts the AIFM about a potential investment in an AIF managed by such AIFM based on the investor’s own initiative, are not covered by the KAGB marketing rules.<sup>57</sup>

In practice, this may allow certain foreign AIFMs with a very limited German investor base some leeway to stay outside of the remit of the KAGB if they cease any targeted AIF marketing in Germany but instead rely on their existing customer base to contact them periodically or sporadically about any new AIFs they set up. As with many of the new definitions and concepts in the KAGB, only time will tell to what extent this reverse solicitation exemption will have a meaningful scope.

#### 3.3 Ready to Sign Documentation

One further potential grey area where interested industry circles had raised concerns during the legislative procedure has recently been clarified by guidelines issued by BaFin after the entry into force of the KAGB. There had been some uncertainty as to the level of documentation regarding an AIF that already needed to exist for the definition of marketing in the KAGB to apply. This became a potential issue already prior to the entry into force of the KAGB because some AIFMs or funds initiators were wondering whether new AIFs that were already designed in principle but not yet at the level of “ready to sign” documentation might qualify for the protection of existing funds accorded by grandfathering rules under the KAGB or similar national laws implementing the AIFMD.

BaFin has recently published a number of guidelines, in the form of frequently-asked questions, on various aspects of the KAGB.<sup>58</sup> With regard to the notion of marketing in section 293 of the KAGB, BaFin published one such guideline on FAQs on July 4, 2013.<sup>59</sup> In section 1.1 of this guideline, BaFin has clarified that the term investment assets in the above marketing definition requires the UCITS or AIF to be in an advanced procedural status for it to qualify. The term covers funds that are either already available in the market or, at least, ready to be invested in. If only an early-stage investment memorandum exists or the offer documents still contain gaps or investment terms in need of further negotiations, such funds do not qualify as investment

<sup>57</sup> For private investors, such reverse solicitation exception does not exist.

<sup>58</sup> *Wollenhaupt/Beck*, DB 2013, p. 1950, 1950, footnote 4 provides a list of the various BaFin guidelines recently published.

<sup>59</sup> BaFin guideline WA 41-Wp 2137-2013/0293, Häufige Fragen zum Vertrieb und Erwerb von Investmentvermögen nach dem KAGB, available online at <http://www.bafin.de>.

assets that are already being marketed and, thus, do not trigger the protection provided by the grandfathering rules.

#### 3.4 Secondary Sales by Existing Investors

One further noteworthy clarification BaFin has provided in the same guideline has been that the sale of interests or shares in investment assets by existing investors to other investors does, in principle, not qualify as marketing within the meaning of the KAGB. Therefore, secondary sales of funds participations by existing investors are not covered by the new marketing rules. This is the case because the purpose of the KAGB is to protect investors, not to “prohibit investors from disposing of their interests or shares.”<sup>60</sup> However, BaFin points out as a caveat in the same FAQ that secondary sales would not be exempt in circumvention scenarios where a mediator basically acquires the shares or interests in a first step in order to then sell them off by way of secondary sales to other investors.

#### 3.5 Structure of the Marketing Regime

Based on the above marketing definition, Chapter 4 of the KAGB then deals with the marketing of investment assets. In line with the fundamental dichotomy between UCITS and AIFs as any other investments assets that are not a UCITS, sections 294 and 295 of the KAGB are the corresponding gating provisions.

In a nutshell, Chapter 4 on marketing can be classified into rules that deal with the civil law relationship between the marketing entity, on the one hand, and the acquiring investor, on the other hand. This relationship is governed by sections 297 through to 308 of the KAGB. Genuinely regulatory provisions with regard to marketing, i.e. the applicable notification procedures, are in turn governed by sections 309 to 336 of the KAGB.

Finally, the applicable marketing regime is dependent on the geographical origin of the marketed investment assets, the classification of the acquiring investor and the point in time when marketing activities are first initiated.<sup>61</sup>

## IV. Future Marketing and Other Key Requirements Under the KAGB for Non-German AIFMs and AIFs

### 4.1 Casuistic Approach

The KAGB contains a considerable number of provisions on the marketing of AIFs. In keeping with its casuistic approach, the KAGB contains different sets of rules for the marketing to private, semi-professional or professional investors. The KAGB marketing provisions further differentiate depending on the geographic origin of both the AIF and the AIFM. Lastly, the KAGB contains a specific set of marketing rules for the time period until the delegated act by the European Commission will be adopted in accordance with Articles 66(3), 67(6) of the AIFMD<sup>62</sup> due to the staged availability of the passport system.

<sup>60</sup> BaFin guideline WA 41-Wp 2137-2013/0293, section 1.3.

<sup>61</sup> See also *Wollenhaupt/Beck*, DB 2013, p. 1950, 1957 with further references. The applicable rules with regard to the marketing of non-German AIFs by a non-German AIF, i.e. the inbound marketing scenarios which this article highlights, shall be described in more detail below.

<sup>62</sup> See section 295(2) of the KAGB.

### 4.2 The European Passport System

The rationale behind the AIFMD has been to create an internal market for AIFMs and provide for a harmonized and stringent regulatory and supervisory framework within the EU for all AIFMs.<sup>63</sup> This goal will be achieved by a harmonized European passport regime whereby AIFMs are regulated only by the member state in which they are domiciled (either directly or by reference) and pursuant to which AIFMs are then permitted to market throughout Europe without further certification. The KAGB reflects this European passport regime by containing provisions on the registration of German AIFMs as well as on the registration of Non-EU AIFMs for which Germany is the chosen reference country through whose competent authority the Non-EU AIFM has registered for the European passport.

While the passport system has already been available for EU AIFMs since July 22, 2013, for those constellations that have a connection to a non-EU state (i.e. Non-EU AIFMs performing management and/or marketing activities within the EU or EU AIFMs managing Non-EU AIFs) the passport mechanism will only at a later stage become available after a transitional period of at least two years (with the adoption of the delegated act by the European Commission according to Articles 66(3), 67(6) of the AIFMD).<sup>64</sup>

#### 4.2 Pre- European Passport System Marketing Provisions

The KAGB reflects this staged availability of the passport system stipulated in the AIFMD. As such, it provides for a specific set of interim rules applicable to the marketing of AIFs for which the European passport system only becomes available at a later stage with the adoption of the delegated act by the European Commission. These provisions especially provide for prior notification obligations vis-à-vis BaFin before a new AIF can be marketed to German based investors. For new Non-EU AIFs, this means that marketing can only be initiated after such notification. It also means that marketing without such notification or of fund products that may be permissible under foreign local law but are not KAGB-compliant under German and EU law would be qualified as prohibited investment business in Germany. For the period until the European passport system becomes available expert legal advice should be sought by AIFMs affected by these marketing provisions, while the grandfathering rules of the KAGB should also be considered in such cases.

## V. Grandfathering Rules

Chapter 7, Section 2 of the KAGB contains the numerous grandfathering rules. In total, there are 13 separate sections that deal with grandfathering rules for the various types of AIFs and other investment assets like UCITS.<sup>65</sup> In view of the numerous different types of existing funds that may be affected by these grandfathering rules, a detailed assessment would go beyond the scope of this article.

The rules differentiate by type of management entity, location of such management entity, open-end or closed-end funds, special fund types (e.g. real estate

<sup>63</sup> See section 4 of the preliminary remarks to the AIFMD.

<sup>64</sup> See section 4 of the preliminary remarks to the AIFMD and the corresponding section 344 of the KAGB.

<sup>65</sup> Sections 343 to 355 of the KAGB.



funds,<sup>66</sup> hedge funds,<sup>67</sup> or pension funds<sup>68</sup>). Further parameters, including the point in time: (a) when the subscription period for an existing fund lapsed; (b) when marketing activities were first initiated; and (c) when a fund will finally be wound up, as well as considerations along the lines of what kind of activities (e.g. further marketing, no more marketing but further portfolio investments or only very limited management of existing funds until they are being wound up) are being continued after the entry into force of the KAGB on July 22, 2013.

The key grandfathering rule for EU AIFMs and Non-EU AIFMs that are managing closed-end funds is section 353 of the KAGB. This provision provides, *inter alia*, for the non-applicability of the KAGB for closed-end funds if the subscription period for investors has ended prior to the entry into force of the AIFMD and the fund in question is constituted for a period of time which expires at the latest within 3 years after July 22, 2013 as stipulated in Article 61(4) of the AIFMD.<sup>69</sup> Section 353 of the KAGB further provides that EU AIFMs or Non-EU AIFMs managing closed-end EU AIFs or Non-EU AIFs for which marketing has begun prior to July 22, 2013 but whose subscription period has not ended before July 22, 2013 have to notify further marketing activities after July 22, 2013 to BaFin.<sup>70</sup>

## VI. Conclusions

In a nutshell, even this brief and targeted assessment of the KAGB reveals that the German implementation of the KAGB is a very complex codification that involves several potential pitfalls for the investment industry. This is the case on a purely national level (with which most of the KAGB's provisions are concerned), but is also true, maybe even more so, with regard to many international AIFMs and AIFs who may have to brace themselves for coming into contact with the German regulatory authorities for the first time. At the very least, administrative burdens will increase. Often, the involvement of specialist local legal counsel will be required in Germany and indeed other European jurisdictions. The end of the private placement regime in Germany and, at least in the medium-term, other EU jurisdictions is likely to increase the need for all market players to become more familiar with the respective local laws.

Even though both ESMA and BaFin are very active in publishing FAQs and other guidelines, several key concepts in the KAGB and/or the AIFMD are still shrouded in some uncertainty. Again, this may be even more pronounced in international or non-EU constellations which the law almost by definition covers in less detail or by reflex or reference only. At the moment, while a reasonable body of German language literature is in the process of being created, no reliable practical cases or precedents exist.

International AIFMs are well advised to exercise special care whenever they intend to market AIFs to German private investors. In this area not expressly covered by the AIFMD, the KAGB creates genuinely new, independent legal provisions very much characterized by a strong spirit of investor protection and an emphasis on tight regulation.

The definitions of "AIFs" at the European level and "investment assets" under German law have been shown to be very broad. This, on the one hand, involves the risk that certain collective structures or well-familiar business models not instantly associated with the untechnical term "investment funds" may be held to be covered by those definitions. On the other hand, several exceptions do exist to limit the potential excesses of such a "material or substantive" funds concept. It is definitely worthwhile to closely analyze these exceptions. Similarly, the definition of "marketing" may also allow for creative solutions in some cases. Such thorough analysis should occur as early as possible in the structuring process in order to canvass all structuring options with a view to potentially avoiding or limiting the applicability of the KAGB.

At least for an interim period, the same is true for the grandfathering rules applicable to existing AIFs. Again it can be useful to assess them early on to decide on the most beneficial approach with regard to the continued existence of "old" AIFs.

With regard to the non-German AIFM itself and its marketing of AIFs into Germany, for the time being no manager registration or application for a European passport is necessary. At least until July 2015 (and maybe even longer) it is predominantly a case of the AIFM waiting for the delegated act of the Commission pursuant to Article 67(6) of the AIFMD. However, EU AIFMs may, of course, have to comply with stricter rules that govern their local activities before this point in time in accordance with the national rules in their home jurisdiction implementing the AIFMD. New Non-EU AIFs require prior notification with BaFin before they can be marketed to German professional or semi-professional investors.

<sup>66</sup> Section 346 of the KAGB.

<sup>67</sup> Section 350 of the KAGB

<sup>68</sup> Section 347 of the KAGB.

<sup>69</sup> Section 353(3) of the KAGB.

<sup>70</sup> Section 353(6), 351(5) of the KAGB.