

NEW GERMAN LICENSE REQUIREMENT FOR INVESTMENT MANAGEMENT ACTIVITY

March 27, 2009

To Our Clients and Friends:

After months of vigorous discussion, the German Banking Act (*Kreditwesengesetz*, “KWG”) has been amended to add “Investment Management” (*Anlageverwaltung*) as a new type of licensable financial service activity. As of March 26, 2009, most foreign closed-end funds (including hedge funds) organized in any form and not subject to regulatory supervision in the country of organization will need a license under the KWG if they have two or more German individual investors (whether sophisticated or not). Entities formed as trusts with individual investors will also need a license. Importantly, however, private equity funds, foreign open-end funds¹ and foreign closed-end funds regulated in their home country will not require a new license. And for family offices, no changes should result from the amendment.

The amendment closes a regulatory gap created in a February 2008 decision of the German Federal Administrative Court (*Bundesverwaltungsgericht*)². The purpose of the amendment is to protect German individuals against risky investment schemes.

WHAT IS “INVESTMENT MANAGEMENT?”

“Investment Management” is defined as

- the purchase and the sale of *financial instruments* (*Finanzinstrumente*, e.g., stocks, bonds, derivatives, money market instruments)
- for collective investment involving *several natural persons*; and
- providing for *discretionary authority* over the selection of the financial instruments.

In every case, the purchase and sale of financial instruments must be the principal feature of the collective investment scheme and it must be structured to permit investors collectively to

¹ “Open-end” means that the investor is entitled to redeem his fund units at least once within a two-year period against full payment of his portion of the net asset value of the fund.

² For details, please see our client update “Uncertain Times Ahead in Germany for Investment Funds,” dated August 5, 2008.

participate in the financial performance of the financial instruments. A collective investment vehicle offered only to institutional investors or a discretionary account for a single individual investor would not meet the definition of Investment Management (although other licensing requirements under the KWG might still apply).

STATUTORY EXCLUSIONS

Foreign investment funds. Certain foreign investment funds that issue so-called “foreign investment units” as defined under the German Investment Act (*Investmentgesetz*)³ are *specifically excluded* from any licensing requirements under the KWG, including Investment Management, because such funds are already subject to the regulatory scheme of the Investment Act. As a result, open-end foreign investment funds, and foreign closed-end funds that are subject to regulatory supervision in their country of organization, do not require a license. Closed-end foreign investment funds that are not so regulated do not qualify as “foreign investment funds” within the meaning of the Investment Act and, therefore, will require a license under the KWG.

Parent enterprise license; “passporting.” The KWG amendment also excludes enterprises from the licensing requirement if (i) such enterprise provides no other financial services than Investment Management, and (ii) its parent enterprise is licensed for Investment Management. In case the parent enterprise is located in another member state of the European Economic Area (EEA), the subsidiary can provide Investment Management services in Germany if the parent enterprise is licensed for an activity which is “comparable” to Investment Management in its home country. There is no guidance yet on what is considered a “comparable” activity, although the grandfathering rules discussed below may indicate that financial commission business (*Finanzkommissionsgeschäft*), proprietary trading (*Eigenhandel*) and financial portfolio management (*Finanzportfolioverwaltung*) are likely to be considered comparable.

LEGISLATIVE GUIDANCE

Ancillary trading in financial instruments. If the purchase and the sale of financial instruments is an ancillary activity of the collective investment scheme, as is the case for real estate or private equity funds, such activity does not qualify as Investment Management within the meaning of the KWG. The legislative reasoning published with the amendment makes clear that private equity funds purchasing shares in a stock corporation, with the intent to exert operational influence on the target’s management and business decisions rather than

³ For details regarding the qualification as foreign investment fund under the German Investment Act, please see our client update “German Regulator Issues New Guidance for Foreign Investment Vehicles,” dated February 4, 2009.

just to benefit from the growth potential of the target's shares, do not fall under the new license requirement.

Investment discretion. If the investment guidelines of a collective investment scheme limit purchases and sales to certain defined financial instruments without permitting permanent active trading, then no license is required because there is a lack of overall discretionary authority over the investment decisions. The same is true for special purpose vehicles created by already regulated credit institutions, because these special purpose vehicles typically restrict discretion over investment decisions and, moreover, do not directly target the individual investor in sales and marketing efforts. In addition, no separate license should be required for an investment vehicle which has outsourced discretionary investment management decisions to a licensed investment manager.

GRANDFATHERING

Existing license. Any institution that, as of March 25, 2009, is already licensed to conduct financial commission business, proprietary trading or financial portfolio management under the KWG does not require an additional license to engage in Investment Management.

Published prospectus. Investment Management activities in connection with collective investment schemes for which a sales prospectus was published on or before September 24, 2008 (the date when the Cabinet passed the bill amending the KWG) are *per se* exempt from the new licensing requirement.

LICENSING REQUIREMENT

Any collective investment scheme which is engaged in Investment Management within the meaning of the KWG, as amended, will require a license if none of the exemptions or grandfathering rules applies – even if it performed such activity prior to the amendment.⁴ The German Financial Services Supervisory Authority (*BaFin*) may, at its discretion, sanction the provision of financial services performed without a required license.

An exemption to the licensing requirement should be available pursuant to the so-called “passive freedom of services doctrine” (*passive Dienstleistungsfreiheit*). Under that doctrine, no license under the KWG is required if the contact between the financial services provider and the client is initiated by the client itself and without prior solicitation. Contacts with existing clients are covered by this doctrine. The passive freedom of services doctrine should also

⁴ The fee for obtaining a license for Investment Management is €4,000. The licensing procedure generally takes several months. The financial institution applying for a license under the German Banking Act has to have its head offices in Germany and requires a minimum capital of €50,000.

apply to Investment Management services. It will be more important than ever for closed-end fund clients to exercise caution when marketing in Germany.

This memorandum is a brief summary of the issues addressed herein and is not intended to be legal advice. For further questions please contact:

Marcia L. MacHarg
+49 69 2097 5120
mlmacharg@debevoise.com

Philipp von Holst
+49 69 2097 5211
pvonholst@debevoise.com

Henri Babin
+49 69 2097 5208
hbabin@debevoise.com

Ina von Raven
+49 69 2097 5213
ivonraven@debevoise.com