

GERMAN REGULATOR ISSUES NEW GUIDANCE FOR FOREIGN INVESTMENT VEHICLES

February 4, 2009

To Our Clients and Friends:

On December 22, 2008, the German Financial Services Supervisory Authority (*BaFin*), released a long-awaited circular on the application of the German Investment Act (*Investmentgesetz*, the “Act”) to foreign investment vehicles (the “Circular”).¹ The Circular contains *BaFin*’s views about how the criteria specified in the Act should be applied to different types of foreign investment funds.

The guidance is significant for our foreign private fund clients in two respects: (i) first, in contrast to prior *BaFin* practice, interests in foreign funds organized as *partnerships* will, if certain criteria are met, now be treated as “foreign investment units” (*ausländische Investmentanteile*, “Foreign Investment Units”) subject to regulation under the Act; and (ii) second, if a foreign private equity fund satisfies criteria specified by *BaFin*, it will *not* be treated as a foreign investment fund and its interests will not be Foreign Investment Units under the Act.

REGULATORY BACKGROUND

In December 2007, the Act was amended to provide that if certain foreign asset pools meet specified criteria, the distribution of units in those funds will be treated as distributions of Foreign Investment Units.

Under the Act, public distribution of Foreign Investment Units is subject to special notification and prospectus requirements and may be prohibited by *BaFin* if the requirements of the Act are not met. Moreover, violation of these requirements constitutes a regulatory offense which can lead to a fine of up to €100,000. And, as recently confirmed by a decision of the Higher Regional Court of Frankfurt, an issuer of Foreign Investment Units who fails to comply with the prospectus and notification requirements of the Act may be subject to damage claims by the individual investors. Finally, qualification as Foreign Investment Units has significant tax implications, as noted below.

¹ The German version of the Circular is available at:

http://www.bafin.de/chn_116/nn_721290/SharedDocs/Veroeffentlichungen/DE/Service/Rundschreiben/2008/rs__1408__wa.html?__nn=true

FOREIGN INVESTMENT UNITS - FORMAL CRITERIA

A foreign fund will be offering Foreign Investment Units if it meets either one of two formal criteria: (i) the fund offers investors redemption rights (open-ended fund), or (ii) the fund is subject to investment supervision.

Redemption Rights. According to the Circular, a fund will be offering redemption rights if an investor is entitled to redeem his units at specified redemption dates at least once within a two-year period. Thus, a fund will be open-ended even if it does not offer investors the right to redeem units against payment at any given time as long as it offers redemption rights at least once within a two-year period. The regular ongoing redemption rights must be available to a majority of the investors in the fund; individual redemption agreements will not be sufficient. For umbrella schemes, each sub-fund (*Teilfond*) will be looked at separately; however, different classes of units in a fund will not be treated separately.

Lock-up periods during which individual investors may not demand redemption of their units will be disregarded if after the expiry of the lock-up period investors may still redeem their units at least once in a two-year period, even if the individual term of the lock-up period exceeds two-years.

Furthermore, in order to have a redemption right the investor must receive full payment of his portion of the net asset value (*Nettoinventarwert*) of the fund (after deduction of redemption fees, transaction charges or similar deductions of up to 15% of the net asset value). The redemption right may be limited to a certain amount if this limit is meant to protect the interests of the investors. The redemption may occur in cash or in kind.

Investment Supervision. *BaFin* has clarified that foreign investment supervision means that there must be public supervision serving to protect the interests of investors in the foreign investment vehicle. Public supervision that only serves to ensure the integrity or efficiency of the market or compliance with tax requirements does not qualify as investment supervision.

To qualify as investment supervision, there must be a check, prior to the issuance of the investments units, of (i) the solvency of the investment company, (ii) the reliability and qualification of the fund managers, and (iii) after issuance, the investment units are subject to compliance with legal, statutory, fund contract or similar provisions regarding the structuring of the portfolio (*e.g.*, investment restrictions).

BaFin has not issued a list of countries which satisfy these requirements. Therefore, for the time being, whether or not a fund is subject to effective investment supervision will have to be checked separately for each closed-ended fund regardless of its jurisdiction.

FOREIGN INVESTMENT UNITS - SUBSTANTIVE CRITERIA

In addition to meeting either one of the two formal requirements summarized above, in order for an interest in a foreign investment vehicle to be a Foreign Investment Unit, it must be issued by (i) a foreign pool of assets for collective investment, (ii) pursuant to the principle of risk diversification, (iii) in eligible assets as defined under the Act.

Assets for Collective Investment. This requirement means that the purpose of the investment pool needs to be investment and management of its assets for the joint account of the unit holders. Significantly, neither the legal form of the investment pool nor the legal form of the investors (whether legal entities or natural persons) matters, as long as the investment pool can admit more than one investor that economically participates in the benefits as well as the risks of the collective investment.

Risk Diversification. The principle of risk diversification requires the assets of the foreign fund to be invested for the purposes of risk diversification in more than three assets with different investment risks. The assets must be held for investment purposes rather than for maintaining liquidity. For a foreign investment fund the principle of risk diversification is also deemed to be satisfied if such foreign investment fund holds to a material extent interests in one or more other funds the assets of which are invested according to the principle of risk diversification (umbrella schemes).

Eligible Assets. A foreign investment pool only qualifies as a foreign investment fund under the Act if more than 90% of its net asset value is actually invested or, according to the fund's investment guidelines, will have to be invested in eligible assets as defined under the Act. Eligible investments including, *inter alia*, securities, money market instruments, derivatives, bank deposits, real estate, participations in real estate companies, units in certain investment funds, precious metals, and uncertificated loan receivables.

Investment Restrictions. It is worth stating here that the Act contains limitations on the ability of publicly offered funds (other than hedge funds) to invest in (i) derivatives, (ii) public private partnerships (PPPs), (iii) precious metals, (iv) uncertificated loan receivables, and (v) equity participations (up to 20%).

EXCEPTIONS FOR PRIVATE EQUITY FUNDS, CDOS AND CERTIFICATES

The Circular specifically addresses the application of the Act to private equity funds, collateralized debt obligations and so-called certificates which have been popular economic substitutes for investment units in Germany mainly for tax reasons. For most of our clients, the *BaFin's* guidance in this area will be welcome, although interpretive questions will inevitably continue to arise.

Private Equity Funds. A fund that invests to a substantial extent in *equity participations* in companies or other assets (*e.g.*, shares of stock) which the fund actively manages in order to increase value is exempt from the definition of investment fund under the Act. The Circular states that specific indicators of such active entrepreneurial activity are (i) the intended or actual acquisition of majority interests or veto rights, (ii) the assumption of decision-making power and responsibility on the company's executive or supervisory bodies (beyond the exercise of shareholders' rights in the annual shareholders' meeting), (iii) cooperation with third parties in ways suitable to permanently or substantially influence the target company's business, (iv) the support of activist management of one or more other private equity funds (*e.g.*, by a fund of funds), and (v) the conduct of due diligence with respect to non-public information prior to the investment in the target company. As a general rule, therefore, private equity funds investing in equity securities of portfolio companies will not qualify as foreign investment funds for purposes of the Act *even if they meet some of the other criteria indicated above.*

Collateralized Debt Obligations (CDOs). CDOs (as well as consumer asset backed securities, commercial mortgage backed securities, collateralized bond obligations and collateralized loan obligations) issued by a special purpose vehicle for the purpose of financing its portfolio are also exempt from the Act and the offering of interests does not constitute the offering of Foreign Investment Units as long as the main purpose of the special purpose vehicle does not consist of the investment and management of its assets for the joint account of the CDO holders.

Certificates. Generally speaking, certificates in Germany are securities issued by a third party, such as a bank, which confer on the purchaser of the certificate a contractual claim against the issuer. Certificates issued by a third party that reflect the economic performance of foreign investment funds only qualify as Foreign Investment Units if the investor enters into a direct legal relationship with the foreign investment fund (a membership interest in the foreign investment fund is not required, however). According to the Circular, a certificate does not qualify as a Foreign Investment Unit if (i) the issuer of the certificate is not obliged to invest the issue proceeds in eligible assets, (ii) the holder of the certificate does not acquire any rights in the underlying assets, and (iii) only has a contractual claim against the issuer of the certificate which depends on the performance of the underlying assets.

RULINGS

BaFin states that it will no longer issue written rulings interpreting these provisions of the Act. Rulings will only be issued in connection with the formal notification of the intended public distribution of investment fund units.

TAX ASPECTS

Aside from the regulatory aspects, the question whether or not units issued by a foreign investment company qualify as Foreign Investment Units is also relevant for tax reasons: In order for a German investor in interests in a foreign investment fund to benefit from the generally favorable taxation on a quasi-look-through basis, the foreign investment fund issuing the units needs to qualify as “transparent” under the German Investment Tax Act (*Investmentsteuergesetz*). If, on the contrary, the foreign fund does not meet the transparency criteria, a penalizing regime applies and the investor is fully taxed on all distributions and, in addition, on 70% of the appreciation of the value of its interest in the fund relative to the end of the preceding calendar year, but at least on 6% of the value of the interest at the end of the current calendar year. In order to qualify for “transparent” treatment and avoid the penalizing regime, the fund has to fulfill rather burdensome reporting and publication requirements. Therefore, a foreign investment fund (such as a foreign private equity fund) issuing investment units to German investors will typically try to avoid a qualification of the units as Foreign Investment Units.

The treatment by *BaFin* of funds as “foreign investment funds” and its units as Foreign Investment Units under the Act has in past practice been an indication of the legal qualification also for tax purposes. While the tax authorities are not legally required to follow the way a fund is qualified by *BaFin*, we note that the Circular was drawn up in close consultation with the German Ministry of Finance which is expected to issue a statement of its own on this matter in the near future.

This memorandum contains only a brief summary of the Circular and some of its effects and is not intended to be legal advice. Please do not hesitate to contact us with any questions.

Marcia L. MacHarg

+49 69 2097 5120

mlmacharg@debevoise.com

Friedrich Hey

+49 69 2097 110

fhey@debevoise.com

Philipp von Holst

+49 69 2097 5211

pvonholst@debevoise.com

Ina von Raven

+49 69 2097 5231

ivonraven@debevoise.com