

# Client Update

## At Long Last—BaFin Issues New Guidance to German Pension Funds on Eligibility of Investment Products

On 12 December 2017, the German Federal Financial Authority (“BaFin”) issued a long-awaited Circular providing guidance on the conditions under which German pension funds and small insurance companies may invest in financial products (the “Circular”).

The Circular applies to regulated investors that are subject to the German Investment Ordinance (*Anlageverordnung*) (i.e., pension funds and small insurance companies) and those which, according to their internal rules, comply with the Investment Ordinance (insurance companies and certain pension schemes). These rules are also relevant for some insurance companies subject to Solvency II, which apply the provisions of the Investment Ordinance on a voluntary basis in accordance with the prudent person principle.

The Circular provides guidance as to the interpretation of the Investment Ordinance, which specifies the asset classes that are eligible investments. While the Circular includes some improvements and clarifications for investors in private equity funds, it does not include any new guidance regarding debt funds and real estate funds.

### **WELCOME CLARIFICATIONS AND IMPROVEMENTS REGARDING INVESTMENTS IN PRIVATE EQUITY FUNDS**

The Circular clarifies the following points regarding investments in private equity funds:

- The Circular, in accordance with the Investment Ordinance, permits investment in equity, equity-like instruments and other forms of business financing. The drafting in the Circular implies that “equity-like instruments” means only profit participation rights (*Genussrechte*), and “other forms of business financing” means receivables from subordinated obligations (*Forderungen aus nachrangigen Verbindlichkeiten*) only. Generally, shareholder loans are considered subordinated to equity claims. However, the analysis may vary depending on the governing law and the specific circumstances, and hence there is a risk that, without further clarification, BaFin may not always consider shareholder loans as eligible investment.

- Private equity funds are only permitted to invest in debt through holding a stake in companies that originate loans, hold such loans and actively monitor such loans.
- Previously, private equity funds were only eligible investments if their borrowing was short-term and limited to 10% of the value of the fund. Both restrictions were problematic because the meaning “value of the fund” and “short term” was unclear. Very helpfully, those limitations have been removed, and borrowing at the fund level is now permitted for bridging capital calls. Unfortunately, uncertainty remains with respect to a fund of funds because BaFin has retained the 10% limitation and the short-term requirement there.
- German-regulated investors often invest through captive vehicles organized as German open-ended special funds. Under the prior draft Circular, German open-ended special funds were not allowed to invest in closed-ended funds, but the new Circular explicitly permits investment in closed-ended private equity funds that comply with the Investment Ordinance.
- According to the Investment Ordinance, private equity funds are only eligible investments if the fund and its manager have their respective seat in an EEA or OECD country. The Circular clarifies that the requirement to have an EEA or OECD seat does not apply at the level of the manager of the target fund in case of a fund-of-funds structures. However, it is still unclear whether the target fund itself is also released from the EEA or OECD seat requirement (although there are good arguments that the target funds should be released). In addition, the Circular does not clarify whether the manager of the target fund must be subject to investment supervision for investor protection purposes and to registration or authorization which is comparable to the German registration or authorization under the German Capital Investment Code.

#### **NO CHANGES TO CLOSED-ENDED REAL ESTATE FUNDS AND DEBT FUNDS**

The new Circular does not include any major changes to the eligibility criteria that have been applied for closed-ended real estate funds and debt funds. In particular:

- Closed-ended real estate funds remain subject to the borrowing limitation of 60% of the market value of the real estate assets held by the fund. In addition, short-term borrowing is permitted up to 30% of the value of the fund.
- Private debt funds would typically fall within the alternative investment basket, which requires EEA seats for both the debt fund and its manager.
- If a regulated investor invests in a real estate or debt fund of funds, the target funds need to fully comply with the look-through requirements of the Investment Ordinance. This means that it is not possible to invest in such a fund of funds that invests in non-EU target funds.

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Please do not hesitate to contact us with any questions.

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