Investment funds in Germany: regulatory overview

Christian Schmies
Hengeler Mueller

RETAIL FUNDS

1. What is the structure of the retail funds market? What have been the main trends over the last year?

Open-ended retail funds
The German market for retail funds is well developed, with the majority of retail funds being undertakings for collective investment in transferable securities (UCITS). The German Capital Investment Code (Kapitalanlagegesetzbuch- KAGB) also allows the establishment of other types of open-ended retail funds which qualify as Alternative Investment Funds (AIFs) within the meaning of Directive 2011/61/EU on alternative investment fund managers (AIFM Directive), particularly open-ended real estate funds (see Question 14).

As of 30 November 2015, German asset management companies managed EUR901 billion in retail funds. Additionally, many asset management companies domiciled in other EU jurisdictions, such as Luxembourg and Ireland, use the European passport under the UCITS directive to distribute their investment funds in Germany to retail investors.

Closed-ended retail funds
Closed-ended retail funds were largely unregulated prior to the implementation of the AIFM Directive into German law in 2013. As of 31 December 2015, members of the industry association (Sachverkehrsverbund) managed EUR160 billion in closed-ended funds. That total included both retail funds and funds for institutional investors.

Regulatory framework and bodies

2. What are the key statutes, regulations and rules that govern retail funds? Which regulatory bodies regulate retail funds?

Open-ended retail funds
Regulatory framework: The German Capital Investment Code 2013 (KAGB) is the main piece of legislation for the regulation of open-ended retail funds.

Regulatory bodies: The German Federal Financial Services Supervisory Authority (Bundesanstalt für Finanzdienstleistungszauficht (BaFin)) is the competent regulatory authority for the regulation of open-ended retail funds.

Closed-ended retail funds
Regulatory framework: See above, Open-ended retail funds: Regulatory framework.

3. Do retail funds themselves have to be authorised or licensed?

Open-ended retail funds
An asset management company (Kapitalverwaltungsgesellschaft) needs authorisation as a management company for undertakings for collective investment in transferable securities (UCITS) or as an alternative investment fund manager (AIFM) if that company both:

• Manages open-ended retail funds.
• Is domiciled in Germany.

UCITS management companies domiciled in other EU/EEA member states can manage German UCITS through:
• The UCITS management passport, on a cross-border basis.
• A branch established in Germany.

The management of German retail AIF by foreign asset management companies is not possible. However, a German AIFM can delegate the portfolio management to foreign asset managers under certain circumstances.

Apart from the authorisation of the management company, the fund rules (Anlagebedingungen) of open-ended retail funds also require approval by the German Federal Financial Services Supervisory Authority (BaFin).

Closed-ended retail funds
An asset management company needs authorisation as an AIFM if that company both:

• Manages closed-ended retail funds.
• Is domiciled in Germany.

Foreign asset management companies are not permitted to manage German retail AIFs. However, a German AIFM can delegate the portfolio management to foreign asset managers under certain circumstances. Apart from the authorisation of the management company, the fund rules (Anlagebedingungen) of closed-ended retail funds also require approval by the BaFin.
4. Who can market retail funds?

Open-ended retail funds
The German Banking Act (Gesetz über das Kreditwesen (KWG)) typically qualifies the marketing of financial instruments as an activity subject to a licensing requirement.

However, the German Trade Ordinance (Gewerberechtigung) provides for a somewhat lighter licensing regime. It provides for an exemption from the licensing requirement under the KWG for distributors who only distribute certain fund units under the German Capital Investment Code (KAGB). Such distributors only need a lighter licence under the Trade Ordinance.

Distributors domiciled abroad can market investment funds in Germany if they:
- Operate under a relevant European passport (for example, the MiFID passport for investment advice under Directive 2004/39/EC on markets in financial instruments (MiFID)).
- Obtained a waiver from the licensing requirement from the German Federal Financial Services Supervisory Authority (BaFin).

Closed-ended retail funds
See above, Open-ended retail funds.

5. To whom can retail funds be marketed?

Open-ended retail funds
The German Capital Investment Code (KAGB) distinguishes three types of investor categories:
- **Professional investors.** This includes all investors qualifying as professional investors under Directive 2004/39/EC (MiFID).
- **Semi-professional investors.** This is a category introduced independently by German legislation, and includes:
  - investors investing at least EUR10 million in a particular fund; and
  - investors investing at least EUR200,000 in a particular fund and satisfying certain additional qualification criteria.
- **Retail investors.** This category comprises all investors not qualifying as professional or semi-professional investors.

Generally, German open-ended retail funds can be distributed to all three types of investor. Foreign open-ended retail funds can be distributed to all three types of investors if benefitting from a UCITS passport. Foreign open-ended retail funds without a UCITS passport can be marketed to professional and semi-professional investors if benefitting from a passport under AIFMD. However, they can only be marketed to retail investors after successful completion of a national notification procedure with BaFin which requires that the foreign open-ended retail fund is established and operated substantially in accordance with the provisions applicable to one of the German open-ended retail fund types foreseen by the KAGB.

Closed-ended retail funds
See above, Open-ended retail funds.

Managers and operators

6. What are the key requirements that apply to managers or operators of retail funds?

Open-ended retail funds
An asset management company domiciled in Germany and managing open-ended retail funds generally needs authorisation as an UCITS management company or as an alternative investment fund manager (AIFM). The licensing requirements for UCITS management companies and for AIFM are essentially based on the requirements of the following European Directives:

A foreign asset management company can manage a German UCITS fund but cannot be the AIFM for other German retail funds. However, the German AIFM of such German retail fund can under certain circumstances delegate the portfolio management to a non-German asset manager.

Closed-ended retail funds
See above, Open-ended retail funds

Assets portfolio

7. Who holds the portfolio of assets? What regulations are in place for its protection?

Open-ended retail funds
The legal owner of assets in contractual-type funds is either:
- An asset management company holding the assets in trust for investors.
- The community of investors.

The legal owner of corporate-type funds is the fund itself. The main instrument of protection for fund assets is the mandatory appointment of a depository. The depository must be entrusted with the safekeeping of the fund's assets which can be held in safe custody and with ownership control of other assets.

Closed-ended retail funds
See above, Open-ended retail funds. However, closed-ended retail funds cannot be established as a contractual-type fund under the KAGB.

Legal fund vehicles

8. What are the main legal vehicles used to set up a retail fund and what are the key advantages and disadvantages of using these structures?

Open-ended retail funds
Legal vehicles. There are two types of legal structures under which open-ended retail funds can be established under the German Capital Investment Code (KAGB):
- **Contractual-type fund (Sondervermögen).** This is the primary legal structure used for establishing open-ended retail funds in Germany. It is a pool of assets lacking legal personality. This type of fund is managed by an asset management company that does not form part of the insolvency estate of the asset management company. Its legal structure is similar to that of...
Luxembourg’s common fund (fonds commun de placement) (FCP).

- **Investment stock corporation.** Open-ended retail fund can also be established as an investment stock corporation with variable capital (Investmentaktiengesellschaft mit veränderlichem Kapital). This legal form is akin to Luxembourg’s investment company with variable capital (société d’investissement à capital variable) (SICAV).

**Closed-ended retail funds**
There are two types of legal vehicles for closed-ended retail funds:
- Investment stock corporation with fixed capital.
- Closed-ended limited partnership.

**Investment and borrowing restrictions**

9. What are the investment and borrowing restrictions on retail funds?

**Open-ended retail funds**
The German Capital Investment Code (KAGB) provides for five types of open-ended retail funds:
- Undertakings for collective investment in transferable securities (UCITS).
- Balanced funds (Gemischte Investmentvermögen).
- Other investment funds (un klassifiziert).
- Hedge funds (Dach-Hedgefonds).
- Real estate funds (Immobilien-Sondervermögen).

Investment and borrowing restrictions applicable to open-ended retail funds vary according to the type of retail fund. UCITS are the most important type of retail fund (see Question 7). Investment and borrowing restrictions for UCITS are generally limited to those foreseen by Directive 2009/65/EU (UCITS).

**Closed-ended retail funds**
Closed-ended retail funds are limited to a catalogue of eligible assets. Apart from financial instruments, this catalogue contains a broad range of physical assets, such as:
- Real estate (including forests).
- Ships.
- Aeroplanes.
- Containers.
- Others.

Closed-ended retail funds are subject to the following rules in terms of risk:
- A maximum of 30% of assets may be subject to currency risk.
- Borrowing is capped at 60% of the fund’s net asset value.
- Investments must follow the principle of risk diversification. However, this requirement does not apply if certain requirements are met, the most important of which is a minimum investment of EUR20,000.

10. Can the manager or operator place any restrictions on the issue and redemption of interests in retail funds?

**Open-ended retail funds**
There is generally no obligation to issue units in open-ended retail funds. The redemption requirements applicable to retail funds, in particular the frequency of redemptions, depend on the relevant fund type (see Question 9, Open-ended retail funds).

**Closed-ended retail funds**
There is generally no obligation to issue units in closed-ended retail funds. Closed-ended retail funds generally do not offer redemptions.

11. Are there any restrictions on the rights of participants in retail funds to transfer or assign their interests to third parties?

**Open-ended retail funds**
There are generally no restrictions on the rights of participants in open-ended retail funds to transfer or assign their interest to third parties.

**Closed-ended retail funds**
See above, Open-ended retail funds.

**Reporting requirements**

12. What are the general periodic reporting requirements for retail funds?

**Open-ended retail funds**

- **Investors.** An annual report and a semi-annual report must be published. Additional reporting requirements apply when special events occur (for example, the liquidation of the fund).

- **Regulators.** The German Capital Investment Code (KAGB) provides for reporting requirements to the German Federal Financial Services Supervisory Authority (BaFin) in terms of the:
  - Asset management company that is managing open-ended retail funds.
  - Open-ended retail funds managed by the management company.

**Closed-ended retail funds**

- **Investors.** For closed-ended retail funds, both an annual report and a semi-annual report must be published. Additional reporting requirements apply in cases of special events (for example, the liquidation of the fund).

- **Regulators.** The KAGB provides for reporting requirements to the German Federal Financial Services Supervisory Authority (BaFin) in terms of the:
  - Management company that is managing closed-ended retail funds.
  - Open-ended retail funds being managed.
Tax treatment

13. What is the tax treatment for retail funds?

Open-ended retail funds

Funds. The Investment Tax Act (Investmentsteuergesetz, InvStG) provides for two tax regimes:

- Investment funds (Investmentfonds) as defined for tax purposes. To qualify as such tax-privileged investment fund, the respective fund must meet certain tax-specific requirements set out in the InvStG (for example, compliance with particular asset eligibility criteria). These privileged investment funds are exempt from corporate income tax and trade tax. The taxable income from these investments is subject to taxation exclusively at the level of the investor.

- Investing companies (Investitionsgesellschaften), which are depending on their legal form — either partnership investing companies (Personeninvestitionsgesellschaften) or capital investing companies (Kapitalinvestmentsgesellschaften). Partnership investing companies are fully tax transparent, like regular partnerships. In contrast, capital investing companies are subject to German corporate income tax and trade tax. Additionally, income distributed by the capital investing company is subject to:
  - individual or corporate income tax;
  - trade tax at the level of the German or non-German tax-resident investor.

Resident investors. In cases of privileged investment funds, each resident investor is generally subject to individual, corporate and potentially trade tax on:

- Distributed income.

- Income considered to be distributed (as per the end of a fund’s fiscal year) by the investment fund as the investor had received such income directly from the same source as the investment fund. However, the privileged tax regime will only apply provided that the fund complies with very detailed information and publication requirements imposed by the InvStG.

Otherwise, the investor may suffer a punitive taxation. Different tax consequences apply depending on the underlying income sources such as dividends, capital gains and income from leasing.

Non-resident investors. Investors in this category are only subject to (limited) German taxation with respect to specific income items derived by a German investment fund. German individual or corporate income tax owed from such income is generally paid by a deduction of German withholding tax from the distribution or deemed distribution of the investment fund’s earnings in an amount of 26.375%. Withholding tax applies to income from:

- German-sourced dividend income.
- German-sourced leasing income.
- Capital gains from the disposal of German situs real property received by the investment fund.

Depending on the investor’s tax residence, such withholding tax may be reduced and refunded to the investor based on a tax treaty between Germany and the investor’s jurisdiction.

Closed-ended retail funds

See above, Open-ended retail funds

Typically, closed-ended retail funds do not qualify as tax-privileged “investment funds” but rather as partnership investing companies or capital investing companies.

Quasi-retail funds

14. Is there a market for quasi-retail funds in your jurisdiction?

In addition to undertakings for collective investment in transferable securities (UCITS), there have been other regulated, open-ended funds in Germany for many years prior to the implementation of the AIFM Directive into German law, in particular open-ended real estate funds (see Question 9).

The German Capital Investment Code (KAGB) provides for “institutional funds”, commonly known as special funds (Spezial-Investmentvermögen). Prior to the implementation of the AIFM Directive into German law, special funds were only accessible to non-natural persons as investors. With the implementation of the AIFM Directive into German law, German legislation made special funds accessible to semi-professional investors (see Question 9).

Reform

15. What proposals (if any) are there for the reform of retail fund regulation?

The German Federal Parliament has recently adopted legislation to implement UCITS V Directive into German law. UCITS V must be implemented into German law by 18 March 2016. Key aspects of UCITS V and the related implementing legislation are:

- Depositary rules.
- Remuneration requirements for UCITS management companies.
- Tightened provisions on sanctions.

HEDGE FUNDS

16. What is the structure of the hedge funds market? What have been the main trends over the last year?

German legislators introduced a regulatory framework for German hedge funds in 2003, but interest in these types of funds has not been very significant.

The German Capital Investment Code (KAGB) provides for special funds which make up a significant part of the German investment fund market (see Question 14). With more than EUR1.3 billion assets under management in special funds as of 30 November 2015, German asset management companies manage more assets in special funds than the EUR901 billion managed in retail funds.

Regulatory framework and bodies

17. What are the key statutes and regulations that govern hedge funds in your jurisdiction? Which regulatory bodies regulate hedge funds?

Regulatory framework

The German Capital Investment Code (KAGB) is the main piece of legislation for the regulation of special funds.

Regulatory bodies

The German Federal Financial Services Supervisory Authority (BaFin) is the competent authority for the regulation of special funds in Germany.
18. How are hedge funds regulated (if at all) to ensure compliance with general international standards of good practice?

Risks. German asset management companies managing special funds (including single hedge funds) must generally be licensed as alternative investment fund manager (AIFM) under the German Capital Investment Code (KAGB). Consequently, the investment funds they manage are subject to Directive 2011/61/EU (AIFM Directive) risk management requirements, as implemented in the KAGB.

Valuation and pricing. In implementation of the AIFM Directive, the KAGB contains mandatory provisions on the valuation and pricing of fund assets. In particular, the assets belonging to a German special fund must be valued by either:

- An external valuer.
- A valuation function within the asset management company which is independent from the portfolio management.

Systems and controls. German asset management companies managing special funds (including single hedge funds), must generally be licensed as AIFM under the KAGB. As such, the investment funds they manage are subject to the organisational requirements of the AIFM Directive as implemented in the KAGB.

Insider dealing and market abuse. No provisions specifically address insider dealing or market manipulation by German asset management companies that manage special funds. However, like any other financial market actors, German asset management companies that manage special funds are subject to the German Securities Trading Act (Wertpapierhandelsgesetz) and its provisions on insider dealing and market abuse.

Transparency. The KAGB provides for particular transparency requirements for asset management companies managing AIF when they have acquired control of non-listed companies and issuers (Articles 26 to 30, AIFM Directive).

Money laundering. German asset management companies qualify as institutions which are subject to the requirements of the German Anti-Money Laundering Act (Geldwäschesgesetz).

Short selling. German asset management companies are subject to EU Regulation No. 236/2012 on short selling and certain aspects of credit default swaps when engaging in short sales. Short sales are generally prohibited for open-ended German retail funds, and even among special funds short sales have limited practical relevance and are essentially limited to the few German, single hedge funds.

Investment restrictions

21. Are there any restrictions on local investors investing in a hedge fund?

Special funds, which include hedge funds, are only available to professional investors and semi-professional investors. They are not available to retail investors (see Question 20, Special funds).

Certain types of German institutional investors are subject to statutory investment restrictions of their own. This in particular applies to smaller German insurance companies not subject to Solvency II as well as pension funds (Pensionskassen) and certain professional retirement schemes (Versorgungswerke).

Assets portfolio

22. Who holds the portfolio of assets? What regulations are in place for its protection?

See Question 7, Assets portfolio.

Requirements

23. What are the key disclosure or filing requirements (if any) that must be completed by the hedge fund?

German asset management companies must disclose certain mandatory information as prescribed by the German Capital Investment Code (KAGB) in accordance with the disclosure requirements within Article 23 of the AIFM Directive for each special fund that they manage.

Additionally, an annual report must be prepared for each special fund. The requisite content of these annual reports is prescribed by the KAGB in accordance with Article 22 of the AIFM Directive.

24. What are the key requirements that apply to managers or operators of hedge funds?

An asset management company domiciled in Germany and managing German special funds, (including single hedge funds), generally needs authorisation as an alternative investment fund manager (AIFM). The requirements for obtaining such licensing and the ongoing requirements to maintain such licensing are generally based on the AIFM Directive.

Legal fund vehicles and structures

25. What are the main legal vehicles used to set up a hedge fund and what are the key advantages and disadvantages of using these structures?

See Question 8, Legal fund vehicles.

Tax treatment

26. What is the tax treatment for hedge funds?

See Question 13, Tax Treatment.
27. Can participants redeem their interest? Are there any restrictions on the right of participants to transfer their interests to third parties?

Redemption of interest

German special funds can be established as an open-ended fund or as a closed-ended fund. For open-ended funds, the applicable redemption provisions depend on the fund rules. Interests in closed-ended funds cannot be redeemed.

Transfer to third parties

Asset management companies handling special funds must reach a written agreement with investors stipulating that their interests can only be transferred to professional or semi-professional investors.

28. What (if any) proposals are there for the reform of hedge fund regulation?

In the context of the implementation of UCITS V into German law, the German legislator also introduces new rules on loan funds in Germany. There are currently no significant proposals to reform regulations for German special funds.

ONLINE RESOURCES

German Federal Financial Services Supervisory Authority (BaFin)

W www.bafin.de

Description. BaFin maintains a website where it publishes information on the regulation of investment funds. Some parts of the website are available in English.

Practical Law Contributor profiles

Dr Christian Schmies, Partner
Hengeler Mueller Partnerschaft von Rechtsanwälten mbB
T +49 69 17095 975
F +49 69 17095 7142
E christian.schmies@hengeler.com
W www.hengeler.com

Professional qualifications. Admitted to German bar, PhD University of Bonn

Areas of practice. Investment funds; banking regulation; payment services.