



German Fund Legislation – Upcoming Changes

On 24 October, after thorough discussions since Feb 2007¹, the Finance Committee of the Lower House of German Parliament finalized the wording of the changes to the German Investment Act (Investmentgesetz), the regulatory provisions for (mutual / hedge) funds domiciled in Germany and non-German funds marketed into Germany. Some of the revisions have an effect on German fund tax law.

The revision of the law has not yet been enacted but it is unlikely that the wording will be altered during the further legislative process. It is expected that the new law will become effective on 1 Jan 2008.

This WTS Frankfurt/M. Info Letter highlights the main changes proposed, focusing on the interests of the non-German fund promoters and their service providers.

This Info Letter briefly evaluates 3 aspects of the envisaged provisions:

1. Public Distribution of Fund Units
2. Scope of Application of German Fund Legislation
3. Structural Changes to the German Fund Industry

Introduction

The competition for (German) assets under management has reached the conscience of the German legislator. Will the outflow of German assets from German domiciled vehicles continue? The German legislator intends to enhance the competitiveness of the German fund industry compared to successful fund production platforms such as Dublin and Luxembourg. Also, there is a need to counter the problems of the German public pension system with increased private accumulation of capital.

The new legislation intends to help develop Germany as a centre for the production of funds: flexibility will increase through the introduction of new permitted asset classes

¹ WTS described the changes to the German fund regulatory environment - as originally proposed - in its WTS FS Info Letter # 1 – 2007, dated 6 Feb 2007.



and fund types, innovative fund products will be easier to launch. Fund regulatory bureaucracy will decrease.

In order to gain a level playing field for German funds and to avoid fund regulatory arbitrage within the EU, the changes aim to implement the UCITS III directive on a one to one basis, unlike in the past when the German regulatory rules often exceeded the minimum standards required by the EU.

Details

The following details are noteworthy, especially from the perspective of the non-German fund industry.

1. Public Distribution of Fund Units

For the first time, provisions of primary legislation will be introduced that define acts, which do NOT qualify as public distribution of fund units in Germany. By differentiating between marketing to institutional investors and retail investors, the legislator responds to the need of the market. In the past, many non-German funds refrained from entering the German market due to uncertainty and the possibility to be subjected to the supervision of German public distribution rules.

Under the new legislation, there is no violation of the German rules on public distribution:

- if fund units are marketed exclusively to institutional investors like banks, insurance companies and investment funds.
- if the sales prospectus of an umbrella fund (especially an EU-passported UCITS III fund), which has at least one sub-fund permitted for public distribution in Germany, mentions additional sub-funds without such permission, then there shall be no violation of the rules on public distribution as long as the sales prospectus clearly states that the fund units of the latter group of sub-funds are not marketed publicly in Germany.



- if a fund merely publishes annual German tax information via the Electronic Federal Gazette or the name of the fund plus its issue / redemption price.
- if a fund listed on a German stock exchange fulfils the publication requirements that the exchange imposes.

However, a somewhat grey area remains because marketing to family offices and to non-regulated corporate investors is not covered by the explicit exemptions mentioned above.

2. Scope of Application of German Fund Regulatory and Tax Rules

The fine-tuned scope of application is of high importance for non-German fund promoters because the scope defines the eligibility of investment vehicles for German regulated investors such as funds or insurance companies. Also, the scope of application determines the tax regime for the German investor. Finally, the scope of application of the fund regulatory rules delimits the need for permission for public distribution.

The scope of application of the German fund law on the regulation of funds and on the taxation of their investors will be both limited and extended.

a) Limitation

The scope will be limited because – unlike in the past – participations in fund vehicles shall qualify as fund units within the meaning of German fund regulatory and fund tax rules, only if:

- the redemption of the fund units is allowed or
- in case that redemption is not allowed, if the vehicle is subject to investment supervision in its country of domicile.

This means that there will be a clearer separation between funds and non-funds, although the new formal definition does leave room for interpretation: What frequency of redemptions suffices? Are lock-up periods acceptable? What quality of supervision is needed in order to meet the criterion of "investment supervision"?



German investors invested in non-German non-fund vehicles will be subject to the general German income tax regime, including CFC rules. These rules, compared to the special German fund tax provisions, will usually cause less reporting requirements for the vehicle; however, in most cases, will bring about less tax benefits to the investor. Nevertheless, the new regime may also provide for repackaging opportunities.

b) Extension

At the same time, the scope of application of the German fund regulatory rules will be extended, due to the introduction of new asset classes as well as new fund types (i.e. the Infrastructure Fund and the Other Fund).

The new asset classes introduced by the legislation are:

- broad definition of derivatives, e.g. futures on commodities are no longer limited to commodities traded on a regulated exchange
- public private partnership participations
- loans which do not have the legal form of a security
- Micro Finance Loans

The first change to be noted is that the scope of derivatives that (German domiciled) hedge funds are allowed to invest in – without losing their status as a fund under German law - is extended. Futures on commodities are no longer limited to commodities traded on a regulated exchange. In effect, all OTC derivatives are now permitted.

The new asset class infrastructure is accompanied by a new type of fund ("Infrastructure Fund"), which is allowed to invest into public private partnership participations and real estate (min. 60% of the NAV). It remains to be seen whether this attempt to tap the assets of funds for the benefit of the government budget will succeed.

From our perspective, the noteworthy change is the introduction of a new domestic fund type called "Other Fund". This new fund type will be able to leverage upon the new innovative asset classes most. The Other Fund is positioned between the usual



UCITS compliant fund and the single hedge fund. The Other Fund is allowed to invest in the assets covered by the UCITS III directive plus private equity (also multi-tier structures, max. 20% of the NAV), single hedge funds (max. 30%), precious metals, specific derivatives and loans (altogether 30%) which do not have the legal form of a security. Especially the latter aspect of the new law provides for very interesting tax and regulatory planning opportunities. Also to be noted: derivatives can - with certain limitations - amount to 60% of the NAV of Other Funds.

Originally, regarding the new asset classes concerning infrastructure and loans, it seems to have been the intention of the German legislator to make these new asset classes eligible only for German fund vehicles. This potential non-harmonisation of the scope of assets for German and non-German funds implied discrimination of non-German funds with an effect on the eligibility for German regulated investors. However, the German legislator noticed the looming conflict with EU rules: the present wording of the law makes clear that non-German funds, if they are comparable to the new category of Other Funds, qualify as funds within the meaning of the German regulatory and tax rules, irrespective of whether they are domiciled inside or outside of the EU.

Finally, regarding Micro Finance Loans, the new Other Fund and the Spezialfonds (including comparable non-German entities) can invest in refinancing instruments issued by Micro Finance Loan Institutions. Such loans require that, inter alia, that the single loan does not amount to more than Euro 5.000 and that the loan is granted for entrepreneurial purposes of the borrower. The Other Fund can invest up to 75% of its NAV into such loans, in case of Spezialfonds such loans can amount to 100% of the NAV. The Micro Finance Loan Institution has to comply with certain requirements.

3. Structural Changes to the German Fund Industry

For non-German market players delivering services to the fund industry such as prime brokers, fund administrators and comparable service providers, the items described below should be of special relevance because the new rules provide new opportunities. The changes mean a substantial adaptation of the German to the international standards.



The new rules are likely to bring about significant structural changes to the German fund industry.

a) Flexibility will increase

The new law introduces differentiation between funds for institutional investors and retail investors. In the past, the rigid framework for retail funds also applied to Spezialfonds (institutional funds), which are only held by institutional investors. An example of the new flexibility is that German Spezialfonds – unlike in the past – will now be allowed to deviate from the regulatory framework of the law that was intended to safeguard retail investors. Noteworthy: in the future, German Spezialfonds can – under certain conditions – invest 100% of the NAV into loans that do not have the legal form of securities.

b) Outsourcing

In the past, the German implementation of UCITS III was based on the German understanding of outsourcing for banking institutions. The new wording on the outsourcing for funds refers mainly to the wording of the UCITS III directive. This will provide for more legal certainty under the minimum standard of the EU directive and should prevent a German individual approach. The German investment management company (= KAG) is no longer a credit institution. Even essential functions of the KAG can be outsourced under the following procedures: there is only a notification of the supervisor after the end of the BY, prior permission is not required. An insourcing asset manager has to be subject to effective supervision. If the asset management decisions are outsourced to an entity domiciled in a non-EU country, then cooperation between the German fund supervisor and the third country supervisor has to be ensured.

c) Prime Broker

The new rules on Prime Brokers reflect the international market standard including close out netting and rehypothecation. The new rules have to be understood as a repair measurement. The prior wording of the law presented legal barriers, which had to be circumvented by administrative practice. It remains to be seen whether this new flexibility will help a German domiciled hedge fund industry.

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