

Client Update

New German Investment Regulation Adopted

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On 25 February 2015, the German Federal Cabinet adopted a regulation amending the German Investment Regulation and the German Pension Fund Capital Investment Regulation (the “Regulation”). The Regulation entered into force on 7 March. The primary purpose of the Regulation is to adapt the investment rules for restricted assets (*gebundenes Vermögen*) applicable to German insurance companies and certain German pension plans to the regulatory framework under the AIFM Directive, as transposed into the German Capital Investment Act (*Kapitalanlagegesetzbuch – KAGB*).

While the Regulation adds a number of restrictions to the rules governing investments by German insurance companies and pension plans, it also facilitates investments in infrastructure projects and high-yield loans. In addition, the Regulation contains substantial improvements as compared to an earlier draft of the regulation (the “Draft”) published by the German Ministry of Finance last year. The Draft would have effectively banned German insurers and pension funds from investing in private equity, debt and real estate funds managed by most non-EEA managers. (See our Client Update of 24 June 2014, <http://www.debevoise.com/insights/publications/2014/06/german-insurers-and-pension-funds-may-effective/>.)

The Regulation grandfathers investments in private equity funds that were made through 7 March 2015, including capital commitments made to a fund through that date, even if they are not drawn down until after that date. It should be noted that the Regulation will apply to most German insurers only through the end of 2015 because, as of 1 January 2016, most German insurers will become subject to the Solvency II rules instead. Only the smallest insurers, in particular those with a premium income of less than five million Euros annually, will continue to be subject to the Regulation, and not the Solvency II rules. However, the Regulation *will* continue to apply to German pension funds after the end of 2015.

The German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht - BaFin*) will provide additional guidance on the interpretation of the Regulation. A new circular (*Rundschreiben*), however, is currently not expected to be available before the end of this year.

NON-GERMAN PRIVATE EQUITY FUNDS

The Regulation permits German insurers and pension funds to invest restricted assets in closed-end foreign private equity funds investing in equity, equity-like interests and other corporate finance instruments, provided that:

- the fund is organised under the laws of a member state of the EEA or a full member country of the OECD, such as the United States; and
- the fund manager is domiciled in a member state of the EEA or a full member country of the OECD, is subject to public supervision for the protection of investors and holds a licence or registration that is comparable to a licence or registration pursuant to the German Capital Investment Act.

For investments in private equity funds managed by fund managers domiciled in a member state of the EEA other than Germany, an AIFM authorisation or “sub-threshold” registration of the fund manager generally is deemed comparable to a German licence or registration for purposes of the requirements outlined above. For investments in private equity funds managed by non-EEA fund managers that are domiciled in full member countries of the OECD outside the EEA, however, German insurers and pension funds will have to determine comparability of the regulatory scheme applicable to non-EEA fund managers on their own prior to investing in the private equity fund.

For example, German insurers and pension funds will need to determine whether registration of a U.S. fund manager as an investment adviser under the U.S. Investment Advisers Act of 1940, as amended (the “Advisers Act”), is a registration that is comparable to a German licence or registration. We believe that inclusion in the Regulation of the concept of a comparable “registration” (as contrasted to the inclusion of only a “licence” concept in the Draft and in other portions of the Regulation) was a positive development that may make it easier for German insurers and pension funds to conclude that a U.S. Advisers Act registration is “comparable” for purposes of the Regulation.¹ However, further

¹ The reference to “registration” was included in the Regulation, we believe, in response to comments on the Draft submitted by the Private Equity Growth Capital Council (“PEGCC”) and other trade associations. In its comment letters during the consultation process, the PEGCC had argued that U.S. Advisers Act registration should be considered comparable for purposes of the Regulation and described the U.S. regulatory regime in some detail. The PEGCC argued that the Regulation, or BaFin guidance, should make

guidance from the BaFin on this point would eliminate any doubt and would be most welcome.

Although the Draft defined private equity funds narrowly, as funds that invested exclusively in equity and equity-like interests, the Regulation helpfully broadens the definition so that it is in line with current BaFin practice. Under the Regulation, private equity funds may invest not only in equity and equity-like interests, but also in debt instruments, so long as the activity of the fund is not limited exclusively to making and holding investments in debt instruments. In addition, the explanatory notes to the Regulation make clear (while the Draft did not) that, to a limited extent, a private equity fund may also hold cash and cash equivalents and use derivatives for hedging purposes.

The requirement that the fund itself must be organised under the laws of a member state of the EEA or a full member country of the OECD is in line with the requirements set forth in the old investment regulations that were amended by the Regulation. It is worth noting that under the old regulations, funds organised under the laws of non-OECD countries often used OECD country feeder funds to address this requirement.

NON-GERMAN PRIVATE EQUITY FUNDS OF FUNDS

In the case of private equity funds of funds, the aforementioned requirements generally apply only at the fund of funds level. In contrast to the Draft, the Regulation does not require investors to look through the fund of funds and determine that each underlying target fund meets the requirements for private equity funds outlined in the preceding section. This change corresponds to comments on the Draft submitted by the Private Equity Growth Capital Council.

NON-GERMAN REAL ESTATE FUNDS

The Regulation permits German insurers and pension funds to invest restricted assets in foreign open- and closed-ended so-called “special funds” (which are open only to professional and semi-professional investors) and closed-ended retail funds investing in real estate and other assets permitted for German real estate funds, provided that:

this clear. While the Draft was revised so that the Regulation now includes the possibility that registration could be comparable, the Regulation and the explanatory notes do not go on to state specifically that a U.S. Advisers Act registration is comparable – and BaFin guidance on this point is not expected to be available in the near term, if at all.

- the fund is organised under the laws of a member state of the EEA; and
- the fund manager is domiciled in a member state of the EEA, is subject to public supervision for the protection of investors and holds a licence that is comparable to a licence pursuant to the German Capital Investment Act.

For a manager domiciled in the EEA outside Germany, an AIFM licence is generally deemed comparable to a German licence. In contrast to the rules for private equity funds discussed above, however, fund managers domiciled in an OECD country outside the EEA are not eligible managers of real estate funds that are permitted investments in this category. Furthermore, for both EEA and non-EEA fund managers, funds organised under the laws of an OECD country outside the EEA are not permitted investments in this category.

NON-GERMAN REAL ESTATE FUNDS OF FUNDS

In the case of real estate funds of funds, as contrasted with private equity funds of funds, the aforementioned requirements apply not only to the fund of funds but also to each underlying target fund.

ALTERNATIVE SPECIAL INVESTMENT FUNDS

The Regulation expands the investment universe for restricted assets of German insurers and pension funds by introducing a new asset class. Those investors may invest up to 7.5% of their restricted assets in “alternative special investment funds”, which are private investment funds – such as debt funds and hedge funds – that do not fit in any of the categories outlined above (or in other categories not discussed in this Client Update), provided that:

- the fund is organised under the laws of a member state of the EEA; and
- the fund manager is domiciled in a member state of the EEA, is subject to public supervision for the protection of investors and holds a licence that is comparable to a licence pursuant to the German Capital Investment Act.

An AIFM licence from another EEA member state is generally deemed comparable for this purpose. As in the case of real estate funds, funds domiciled in an OECD country outside the EEA, or that are managed by fund managers domiciled in an OECD country outside the EEA, are not permitted investments in this category.

It should be noted that alternative special investment funds may invest up to 100% of their capital in non-securitized loan receivables (*unverbriefte Darlehensforderungen*). According to the explanatory notes to the Regulation,

this provision of the Regulation is meant to facilitate, for example, debt investments in infrastructure projects.

INVESTMENT IN LOANS

The Regulation also expands the ability of German insurers and pension funds to invest up to 5% of their restricted assets in a new category of loans, provided that:

- the borrower is domiciled in a member state of the EEA or a full member country of the OECD and is not a credit institution; and
- the loan is adequately secured.

In contrast to the old investment rules, the Regulation does not require in this investment category that, on the basis of the past and expected future developments with respect to the net assets and results of operations of the borrower, the contractual interest payment and repayment appear to be guaranteed. According to the explanatory notes to the Regulation, this new category is meant to facilitate the granting of loans to infrastructure companies and of high-yield loans to companies with a rating below investment grade. However, the borrower must have at least a speculative grade rating.

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Please do not hesitate to contact us with any questions.