

Lercara

Germany

Contributor

Dechert
LLP

Angelo Lercara

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Michael Bayr

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Germany: Alternative Investment Funds

1. What are the principal legal structures used for Alternative Investment Funds?

Alternative Investment Funds (AIFs) are primarily established using these legal structures: *Sondervermögen*, *Spezial-Sondervermögen*, investment stock corporations, and limited investment partnerships (*Investmentkommanditgesellschaften* or *InvKG*).

Sondervermögen and *Spezial-Sondervermögen* are AIFs in contractual form and do not have legal personality. They consist of asset pools, where investors have joint or beneficial ownership in proportion to their holdings. *Spezial-Sondervermögen* are a specialized form of *Sondervermögen* tailored for institutional and professional investors.

Investment stock corporations can have either fixed or variable capital and are established as separate legal entities. An *InvKG* is a partnership structure with limited liability for investors and a general partner.

The management of these AIFs is typically carried out by a management company (*Kapitalverwaltungsgesellschaft* or *KVG*), which acts as the alternative investment fund manager (AIFM) and in principle holds the portfolio assets as a trustee. KVGs generally require a license, but a lighter registration regime is available for sub-threshold KVGs. Many German private equity and venture capital funds are managed by sub-threshold KVGs.

2. Does a structure provide limited liability to the investors? If so, how is this achieved?

A fund structure can provide limited liability to the sponsor and/or manager vis-a-vis investors, depending on the specific legal structure of the fund.

For AIFs in corporate form, particularly investment limited partnerships, the liability of investors, who usually participate as limited partners, is limited to the amount of their capital contribution.

AIFs in contractual form, such as the *Spezial-Sondervermögen* and their investors are, as a general rule, not liable for the liabilities of the KVG. This includes liabilities of the KVG arising from transactions that it conducts for the joint account of the investors. Furthermore, the KVG is not authorized to incur liabilities

on behalf of the investors.

3. Is there a market preference and/or most preferred structure? Does it depend on asset class or investment strategy?

Market preferences and preferred structures can vary depending on the target investor base and asset class.

AIFs that are dedicated to institutional and professional investors are predominantly set-up as so called Special-AIFs (*Spezial-AIF*). The specific corporate structure however depends on the asset class. For example, a German private equity fund would typically be established as a closed-end Special AIF in the form of an *InvKG* established as a GmbH & Co *InvKG*. This structure is similar to a closed-ended LP structure. The German legislator has recently introduced the possibility to establish closed ended funds in the form of Special-AIFs also in contractual form (*Sondervermögen*).

Ultimately, the choice of structure depends on factors such as the asset class, investment strategy, target investor base, and regulatory requirements.

4. Does the regulatory regime distinguish between open-ended and closed-ended Alternative Investment Funds (or otherwise differentiate between different types of funds or strategies (e.g. private equity vs. hedge)) and, if so, how?

Yes, there is a distinction between open-ended and closed-ended funds. An AIF can be structured either as an open-end or closed-ended fund. The regulatory regime also differentiates between asset classes.

Open-ended funds typically allow investors to redeem their shares or units at any time, while closed-ended funds have a fixed term and do not offer redemptions during the life of the fund.

Both closed-ended retail funds and closed-ended Special-AIFs must invest primarily in assets that are not financial instruments. This requirement is intended to differentiate between (liquid) open-ended and (illiquid) closed-ended funds. For closed-ended AIFs that are open

to retail investors, the universe of eligible assets is further restricted for the purpose of protecting investors. These additional restrictions apply to retail AIFs in full but apply to Special-AIFs only on a limited basis. Closed-ended AIFs are permitted to invest in real estate, ships and airplanes as well as plants for the generation of electricity from renewable energy, holdings in Public Private Partnership project companies and holdings in special purpose companies, which provide exposure to any such asset(s). Private equity and hedge funds may be subject to specific regulations, such as leverage limits for hedge funds or rules governing the acquisition of controlling stakes in non-listed companies for private equity funds.

5. Are there any limits on the manager's ability to restrict redemptions? What factors determine the degree of liquidity that a manager offers investor of an Alternative Investment Fund?

The manager's ability to restrict redemptions and the degree of liquidity offered to investors depend on the type of AIF and its legal structure.

While the German Investment Code (Kapitalanlagegesetzbuch or KAGB) generally requires for open-ended funds that investors have the right to redeem their shares or units at least once per year, the KAGB provides for the possibility to establish specific redemption notices or periods and to suspend redemptions under exceptional circumstances. The German legislator created tools to manage liquidity risks by introducing redemption gates for swing pricing and by providing for the ability to delay and suspend the execution of redemption requests. The German supervisory authority, Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), has not issued any specific guidance on the application of these tools but it has made it clear that it expects AIFMs to make use of and to implement them appropriately. BaFin expects that the documentation establishing an AIF will include provisions relating to the use of these liquidity management tools.

For closed-ended funds, investors typically do not have redemption rights during the life of the fund. The liquidity of closed-ended funds is generally lower than that of open-ended funds, as they invest in less liquid assets and have a fixed term.

The degree of liquidity offered to investors depends on several factors that the manager must consider when determining the liquidity terms and redemption rights for investors in an AIF. The factors include (i) the legal structure and type of the AIF (open-ended vs. closed-

ended); (ii) the fund's investment strategy and underlying assets (liquid assets like publicly traded securities vs. illiquid assets like real estate or private equity); (iii) the target investor base (retail investors vs. institutional or professional investors); (iv) regulatory requirements and restrictions imposed by the KAGB and other applicable regulations.

6. What are potential tools that a manager may use to manage illiquidity risks regarding the portfolio of its Alternative Investment Fund?

There are various tools that a manager can use to manage illiquidity risks associated with the portfolio of a German AIF. These can include a diversification of investments, liquidity buffer, regular stress testing, liquidity management planning, side pockets, asset-liability management.

For open-ended funds, the KVG may also impose restrictions on redemptions, such as redemption notice periods, redemption fees, or redemption gates, to manage liquidity risks. However, these restrictions must comply with the KAGB and other applicable regulations. German lawmakers also introduced the use of swing pricing mechanism into German law. Under exceptional circumstances, a manager of an open-ended AIF can suspend redemptions. Based on a recent survey among KVGs conducted by the BaFin, KVGs have introduced LMTs for retail funds primarily in the form of redemption restrictions, and for Special-AIFs in the form of redemption notice periods.

7. Are there any restrictions on transfers of investors' interests?

Interests in open-ended AIFs are usually redeemable directly from the fund on a regular basis, which reduces the need for transfers in the secondary market. However, if transfers do occur, they may be subject to the consent of the AIFM.

For closed-ended funds, transfers can be subject to the consent of the General Partner or the AIFM, as mentioned. Additionally, the fund documents or partnership agreement may include other restrictions, such as a right of first refusal for the fund or other investors, lock-up periods, or specific procedures for transfers.

Certain German regulated investors may require the ability to transfer their interests without restriction. This should be provided for in the fund documents or through a side letter, as appropriate.

8. Are there any other limitations on a manager's ability to manage its funds (e.g., diversification requirements)?

There are certain limitations and requirements that a manager must consider when managing German funds, including risk diversification and asset stripping rules for private equity funds. AIFs are subject to risk diversification requirements to ensure that the funds' assets are not overly concentrated in specific investments or sectors.

Private equity funds in Germany must comply with asset stripping rules, which are designed to prevent the extraction of value from portfolio companies to the detriment of the company or its creditors. These rules are in line with the AIFMD and are implemented in the KAGB. The rules restrict certain transactions, such as the distribution of dividends, capital reductions, and share buybacks, within a specified period after the acquisition of a portfolio company.

Depending on the type of fund and its investment strategy, there may be other limitations and requirements, such as leverage limits, liquidity management, reporting obligations, and investor protection measures.

9. What is the local tax treatment of (a) resident, (b) non-resident, and (c) pension fund investors (or any other common investor type) in Alternative Investment Funds? Does the tax treatment of the target investment dictate the structure of the Alternative Investment Fund?

Investment funds are in principle subject to the provisions of the German Investment Tax Act (GITA). Where the GITA applies, German and non-German investment funds are taxed at fund level with respect to certain German source income, including in particular German dividend income and German real estate income. In the case of German dividend income, German withholding tax as a rule must be withheld at source. A reduced withholding tax rate may apply on German dividend income. German source income which is not subject to German withholding tax will be taxed.

Under the GITA, German tax resident investors of an AIF are, in principle, taxable on the distributions of an AIF and capital gains from a disposal/redemption of shares in an AIF and are subject to an annual minimum taxation known as the lump-sum amount. Non-resident investors will not be taxed. Pension fund investors are in most cases tax exempt.

AIFs in the legal form of partnerships are in principle not subject to the GITA. Where closed-ended AIFs are structured as a partnership, the ordinary tax regime applies, and the partnership is considered to be transparent for German income tax and corporate income tax purposes. Furthermore, a partnership may be subject to German trade tax (if the AIF is determined to operate a trade or business). In this case, income which must be allocated to the German permanent establishment (*Betriebsstätte*) of the AIF will be subject to trade tax in Germany at a rate which is determined by reference to the location of the German establishment of the AIF. For certain German tax-exempt pension schemes, making a direct investment in such an AIF could potentially alter their tax-exempt status. This could occur if they invest into partnership interests of a partnership that is either actively operating or is considered to operate a "trade or business" for German tax purposes.

Non-resident investors of an AIF structured as a partnership will be subject to German taxes pursuant to the German general tax rules for non-residents. If more than one investor who is invested in the Partnership who is (i) resident for tax purposes in Germany or (ii) a tax-transparent entity for German tax purposes, a so-called separate and uniform German partnership tax return (*Erklärung zur gesonderten und einheitlichen Feststellung*) pursuant to §§ 179 through 183 of the German General Tax Code (*Abgabenordnung*) must be filed with the competent German tax authorities.

In many cases, both the tax status and preferences of an investor have an impact on the chosen structure of an AIF.

10. What rights do investors typically have and what restrictions are investors typically subject to with respect to the management or operations of the Alternative Investment Fund?

Investors are generally not involved in the management of the AIF. Even though the KVG must act in the best interests of the investors, investors do not have the right to issue instructions. Unless the portfolio management functions have been delegated, responsibility for the selection of the assets remains with the KVG. The KVG is responsible for making the investment decisions in strict compliance with the investment policy. Further restrictions may arise depending on whether the investor is itself subject to a regulatory regime or where the investment is made through another investment vehicle.

11. Where customization of Alternative Investment Funds is required by investors, what types of legal structures are most commonly used?

AIFs that are dedicated to institutional investors and require customization are predominantly set-up as Special-AIFs, although the corporate structure depends on the asset class. For example, a German private equity fund would typically be set up as a closed-ended Special-AIF in the form of an InvKG. Additionally, master-feeder structures can be employed to meet the varying requirements of different investors. Feeder funds can be tailored to address the specific tax and/or regulatory needs of individual investors.

12. Are managers or advisers to Alternative Investment Funds required to be licensed, authorised or regulated by a regulatory body?

AIFs are generally operated by a KVG which manages the portfolio of the AIF or delegates the management to a regulated entity to act as portfolio manager. KVGs require a license from the BaFin to operate under the KAGB.

A special regime applies to so called registered KVG, which are those falling below the relevant threshold of the AIFMD (**Small AIFM**) and/or the KAGB. Where the registered KVG manages only Special-AIFs, the KVG is subject only to registration and reporting requirements. Where it also manages retail AIFs, it is subject to a broader set of rules covering, inter alia, conduct and organisational requirements and depositary obligations.

13. Are Alternative Investment Funds themselves required to be licensed, authorised or regulated by a regulatory body?

BaFin approval is required for the fund rules of AIFs that are open to retail investors. This ensures that the funds meet regulatory requirements and provide adequate investor protection.

In the case of Special-AIFs, which are only eligible for professional or semi-professional investors, no approval is required. Instead, a notification to BaFin is sufficient, reflecting the more sophisticated nature of the investors in such funds and their ability to assess the risks associated with these investments.

14. Does the Alternative Investment Fund require a manager or advisor to be domiciled in the same jurisdiction as the Alternative Investment Fund itself?

A German domiciled AIF does not necessarily require a manager or advisor to be domiciled in the same jurisdiction as the AIF itself. It can be managed on a cross-border basis by an AIFM domiciled within the EU, as long as the AIFM complies with the relevant regulatory requirements under the AIFMD and the KAGB.

The delegate portfolio manager or advisor of the AIF can be domiciled outside of Germany. However, it is important to ensure that the delegation arrangements comply with the applicable regulatory requirements, including those related to the supervision and oversight of the delegated activities.

15. Are there local residence or other local qualification or substance requirements for the Alternative Investment Fund and/or the manager and/or the advisor to the fund?

Yes, there are local substance requirements for managing AIFs, particularly for the KVG.

The KVG must have sufficient substance in Germany to be granted a license to manage funds. This typically involves having an adequate number of staff, proper infrastructure, and resources to manage the AIF effectively. The regulator may expect a double-digit number of staff, but the exact requirements depend on the size of the business and the asset class.

Substance requirements also apply to the entities acting as delegated portfolio managers or advisors where their activity depending on the assets of the fund are subject to a license requirement.

16. What service providers are required by applicable law and regulation?

A depositary must be appointed in addition to the KVG and potentially a delegated portfolio manager. The depositary's primary responsibility is for the safekeeping of a fund's investments, including, in particular, financial instruments that can be entered into an account for financial instruments on the depositary's books and all financial instruments that can be physically transferred to the depositary. For assets which do not qualify as financial instruments, an obligation to verify the legal

ownership of the assets shall apply in place of the safe-keeping obligation.

17. Are local resident directors / trustees required?

Yes, local resident directors are required for the KVG to be granted a license. At least two directors are required that are fit and proper.

18. What rules apply to foreign managers or advisers wishing to manage, advise, or otherwise operate funds domiciled in your jurisdiction?

In principle, acting as a delegate portfolio manager or advising a fund on a cross border basis would be deemed to be providing financial portfolio management or investment advice in Germany which are both regulated activities under the MiFID regime as implemented in Germany. The foreign manager or adviser would need to have passported its services into Germany if based in the EU unless the services were solicited from the German client on the basis of a reverse solicitation. The same applies to non-EU managers and advisers with the exception that a passport would not be available. In the absence of a reverse solicitation, an exemption from the license requirement could be requested from the German BaFin.

Operating a fund in Germany requires a domestic or passported EU-AIFM license or a domestic registration as a Small AIFM.

19. What are common enforcement risks that managers face with respect to the management of their Alternative Investment Funds?

If BaFin, based on its investigations, determines that an entity or person is managing a fund without the required license, it possesses extensive supervisory authority to terminate such arrangements. Should the entity or person fail to voluntarily cease the illicit business upon initial request, BaFin will formally prohibit the continuation of the illegal business and order the winding up of the existing operations. To enforce its measures and orders, BaFin may resort to an administrative process, which includes sealing business premises, threatening, and imposing fines. In cases where an imposed penalty payment is uncollectible, the competent administrative court, upon BaFin's request, may order the coercive detention of the business principals.

20. What is the typical level of management fee paid? Does it vary by asset type?

At the time of writing, a typical level of management fee is 1.5 – 2.5 %. The management fee depends on the size and strategy of the fund.

21. Is a performance fee typical? If so, does it commonly include a "high water mark", "hurdle", "water-fall" or other condition? If so, please explain.

Performance fees are typical for professional investors but have been subject to scrutiny by the German regulator with regard to retail-AIFs. Performance fee calculation normally provides for a high water mark and hurdle rates. Whole-fund waterfalls are generally used. The carried interest is only paid when all drawn capital – irrespective of whether it was used to pay for costs, investments or realised investments – is returned) plus a hurdle rate which is typically between 6 and 8 % p.a.).

22. Are fee discounts / fee rebates or other economic benefits for initial investors typical in raising assets for new fund launches?

Yes, it is not uncommon for fund managers to offer fee discounts, fee rebates, or other economic incentives to initial investors during the launch of a new fund. These incentives can take various forms, such as reduced management or performance fees, or 'founder share' classes with preferential terms.

23. Are management fee "break-points" offered based on investment size?

Yes, break-points and size based discounts are regularly offered. The thresholds vary depending on the size of the fund.

24. Are first loss programs used as a source of capital (i.e., a managed account into which the manager contributes approximately 10-20% of the account balance and the remainder is furnished by the investor)?

First loss programs under which the manager takes the first loss in a fund are only rarely used in Germany.

25. What is the typical terms of a seeding / acceleration program?

Typically, an equity or gross revenue share participation is granted, in which case the seed investor will typically require a certain level of control and transparency over the business. Also, seed transactions may include 'early bird' or seed/founder share classes which are often offered to early-stage investors. These classes will usually bear lower fee rates, often in return for a longer lock-up period and perhaps a higher minimum investment amount. The availability of these classes is often limited to a specified investment amount and/or time period.

26. What industry trends have recently developed regarding management fees and incentive/performance fees or carried interest? In particular, are there industry norms between primary funds and secondary funds?

A trend among institutional investors is performance-based remuneration (carried interest) over fixed, non-performance related fees (such as management fees), which is further limited to cover the costs and expenses necessary to provide performance-oriented incentives.

Institutional investors further expect managers to invest a significant amount of their own capital in the fund to better align interests.

27. What restrictions are there on marketing Alternative Investment Funds?

Marketing AIFs in Germany requires the funds to be registered with the BaFin unless the Fund or AIFM can rely on reverse solicitation. German externally managed AIFs in corporate form are not permitted to market their own shares or interests. Marketing must be performed through the KVG or a licensed intermediary. Sub-threshold KVGs are permitted to market the Special-AIFs that they manage to professional and semi-professional investors without prior registration.

28. Is the concept of "pre-marketing" (or equivalent) recognised in your jurisdiction? If so, how has it been defined (by law and/or practice)?

The German pre-marketing provisions differentiate between pre-marketing and marketing activities based on the following criteria. If the information provided to

prospective professional and semi-professional investors,

- Is not sufficient to enable investors to commit to subscribe units or shares of a particular AIF;
- Does not include subscription forms or comparable documents, whether they are in draft or in final form; or
- Does not include constitutional documents, prospectuses or offering documents of an AIF not yet authorized in final form;

Activities are deemed to be pre-marketing (rather than marketing).

In cases where the AIFM provides any draft prospectuses or offering documents, to be considered pre-marketing, these documents must not contain information that can be deemed sufficient for investors to make an investment decision and they must clearly state that: The information contained does not constitute an offer or an invitation to subscribe for units or shares of an AIF; and the information presented therein should not be relied upon as it is incomplete and subject to change.

If these requirements cannot be met, the activities are deemed marketing and the AIF must be registered for marketing in Germany.

29. Can Alternative Investment Funds be marketed to retail investors?

Yes, in principle, an AIF can be registered for marketing to retail investors, subject to limited exceptions such as single hedge funds. These cannot be marketed to retail investors in Germany. They can only be offered as Special-AIFs, and Special-AIFs are only permitted to be marketed to professional and semi-professional investors.

30. Does your jurisdiction have a particular form of Alternative Investment Fund be that can be marketed to retail investors (e.g. a Long-Term Investment Fund or Non-UCITS Retail Scheme)?

Besides the European venture capital funds (EuVECA), the European Long Term Investment Fund (ELTIF) and the European social entrepreneurship fund (EuSEF), which are governed by European regulations, open-ended and closed-ended retail AIFs are available as AIF investment vehicles for retail investors. Also, the German legislator introduced an open ended infrastructure fund – a fund vehicle that invests in infrastructure projects. Through

these infrastructure funds, private investors can now access this asset class even with smaller amounts. Such types of funds are subject to greater regulation and additional investment restrictions than funds designed for professional investors.

31. What are the minimum investor qualification requirements for an Alternative Investment Fund? Does this vary by asset class (e.g. hedge vs. private equity)?

The KAGB distinguishes three types of investor categories: the professional, the semi-professional and the retail investor.

With regard to the definition of a professional investor, the KAGB refers to the definition of professional clients in Annex II of Directive 2014/65/EU on markets in financial instruments. A Semi-professional investor within the meaning of the KAGB is:

1. any investor which satisfies the following conditions:

- the investor commits to investing a minimum of EUR 200,000;
- the investor states in writing that they are aware of the risks associated with the envisaged commitment or investment;
- the investor's expertise, experience and knowledge have been assessed by the AIFM
- the AIFM is satisfied that the investor is capable of making their own investment decisions and understanding the risks involved and that such a commitment is appropriate for the investor; and
- the AIFM confirms to the investor in writing that it has made the assessment mentioned above and that the prerequisites regarding the investor's capabilities in relation to the intended commitment are satisfied.

2. certain institutions under public law.

3. directors and employees of the AIFM who invest in a fund managed by the AIFM.

4. any investor who commits to investing a minimum of EUR10 million in an investment fund.

The category of retail investors comprises all investors that do not qualify as professional or semi-professional investors.

In general, the above classification does not vary by asset

class, however single manager hedge funds may not be marketed to retail investors.

32. Are there additional restrictions on marketing to government entities or similar investors (e.g. sovereign wealth funds) or pension funds or insurance company investors?

Generally, not. Certain investors such as pension schemes, small insurance companies that do not fall under the Solvency II rules and others are subject to investment restrictions which requires the AIFs or their managers to grant special rights in order to make the funds eligible for these investors.

33. Are there any restrictions on the use of intermediaries to assist in the fundraising process?

In principle, direct interaction between an AIF, duly registered for marketing, its AIFM and the prospective investor does not trigger a broker-dealer type licence requirement. Any such interaction between a prospective investor and an intermediary is subject to a license requirement for the intermediary.

34. Is the use of "side letters" restricted?

The use of side letters is, in principle, permitted. However, a restrictive approach applies with regard to retail-AIFs.

35. Are there any disclosure requirements with respect to side letters?

Yes, any preferential treatment must be disclosed in the marketing document (PPM/prospectus). Furthermore "Side letters" are deemed to be a part of the investment terms and, as a consequence, must be filed with the BaFin.

36. What are the most common side letter terms? What industry trends have recently developed regarding side letter terms?

In most cases, institutional investors request enhanced regulatory reporting and tax filing requirements. Adherence to certain ESG standards has also been a recent trend. Certain regulated investors require the right to transfer their interests without restrictions and certain disclosure commitments from the manager.

Contributors

Angelo Lercara
Partner (Munich)

angelo.lercara@dechert.com



Michael Bayr
Associate

michael.bayr@dechert.com

