This country-specific Q&A provides an overview of alternative investment funds laws and regulations applicable in Germany.

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

Alternative Investment Funds ("AIFs") are generally launched through the following vehicles: Sondervermögen, Spezial-Sondervermögen, Investment stock corporations with fixed or variable capital and limited investment partnerships (Investmentkommanditgesellschaften or InvKG).

Sondervermögen and Spezial-Sondervermögen are AIFs in contractual form and have no legal personality of their own. They are pools of assets and are typically set up under a joint ownership system, in which investors hold joint title to the portfolio in proportion to their respective holdings, or in beneficial ownership, where the management company (Kapitalverwaltungsgesellschaft - "KVG") which acts as the alternative investment funds manager ("AIFM") holds title to the portfolio assets as a trustee. AIFMs must generally be licensed although a light regime (registration) is available for sub-threshold AIFMs. A number of German private equity and venture capital funds are managed by sub-threshold AIFMs.

2. Does a structure provide limited liability to the sponsor and/or manager vis-a-vis investors?

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

As a general rule AIFs in contractual form, such as the Spezial-Sondervermögen and their investors are 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. Also, 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?

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

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 set-up both as an open-end or closed-ended fund. The regulatory regime furthermore makes a distinction depending on the type of assets.

Both closed-ended retail funds and closed-ended Special-AIFs must primarily invest 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.

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Alongside real estate, ships and airplanes, closed-ended AIFs may acquire plants for the generation of electricity from renewable energy, holdings in Public Private Partnership project companies as well as holdings in special purpose companies, which hold the aforementioned asset.

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?

Yes, as far as open-ended funds are affected, German law provides for the possibility to establish specific redemption notices or periods and also to suspend redemptions under exceptional circumstances. The German lawmakers recently introduced the possibility to establish redemption gates for a limited period of time.

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

The KVG may use redemption gates and provide for specific redemption dates. German lawmakers also recently introduced the use of swing pricing mechanism into German law. Under exceptional circumstances, a manager of an open-ended AIF can suspend redemptions.

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

Interests in open-ended AIFs are generally freely transferable subject to the consent of the AIFM. Closed-ended funds can provide for a transfer to be subject to the consent of the General Partner or the AIFM. Certain German regulated investors would need to have free transferability of their interests which would need to be provided for in the fund documents or in a side letter.

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

A risk diversification requirement generally applies. Also, PE Funds must comply with asset stripping rules.

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.

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 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, a direct investment in such an AIF could jeopardize their tax exempt status since they would invest into partnership interests of a partnership which actually operates or is deemed 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.

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 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 AIFM must act in the 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 (Spezial-Sondervermögen) although the corporate structure depends on the asset class. For example, a German private equity fund would typically be set up as a closed-end special fund in the form of an InvKG. In addition, the requirements of different investors can be met by setting up master-feeder structures in which the feeder funds are individually tailored, for example, to the tax and/or regulatory requirements of the 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 fund or delegates the management to a regulated entity to act as portfolio manager. KVGs require a licence from the BaFin to operate under the German Investment Code.

A special regime applies to so called registered KVG, which are those falling below the relevant threshold of the AIFMD (“small AIFMs”) 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 eligible for retail investors. In the case of Special-AIFs, no approval is required; a notification is sufficient. This reflects the more sophisticated nature of the investors in such funds.

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

Not necessarily, a German domiciled AIF can be managed on a cross-border basis by an AIFM domiciled within the EU. Furthermore, the delegate portfolio manager or advisor of the AIF can be domiciled outside of Germany.

15. Are there local residence or other local qualification or substance requirements?

Sufficient substance must be available in Germany for the KVG to be granted a license to manage funds. As a rule of thumb a double digit number of staff would be expected by the regulator. However substance requirements very much 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?

A depositary must be appointed in addition to the KVG which operates the fund or delegates the management to a regulated entity to act as portfolio manager. KVGs require a licence from the BaFin to operate under the German Investment Code.

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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 a financial service in Germany which is a regulated activity 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 AIFM license or a domestic registration as a sub-threshold AIFM.

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

If, on the basis of its investigations, BaFin determines that an entity or person manages a fund without the required license, it has extensive powers as a supervisory authority to terminate such arrangements. If the entity or person does not voluntarily cease the illicit business at first request, BaFin will formally prohibit the continuation of the illegal business and order the winding up of the existing business. If necessary, BaFin enforces its measures and orders via an administrative process and can have business premises sealed, threaten and impose fines. If an imposed penalty payment is uncollectible, the competent administrative court may, at the request of BaFin, also order the coercive detention of the principals of the business.

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?

Founder shares or founder share classes are sometimes used to offer different fee structures or other characteristics in view of a fund launch.

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 fees?

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.

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 using the following three criteria. Activities are deemed to be pre-marketing (rather than marketing) 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.

Also, to be considered pre-marketing, in cases where the AIFM provides any draft prospectuses or offering documents, these documents must not contain information that can be deemed sufficient for investors to make an investment decision and must clearly state that:

- It 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.

Special-AIFs may only be marketed to professional and semi-professional investors. Single hedge funds may only be offered as Special-AIFs. Therefore, single hedge funds can under no circumstances be marketed to retail 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. Such types of funds are subject to stricter regulation and investment restrictions than funds designed for professional investors.

31. What are the minimum investor qualification requirements?

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 2004/39/EC on markets in financial instruments. A Semi-professional investor within the meaning of the KAGB is any investor:

- who commits to investing a minimum of EUR 200,000;
- who states in writing that he is aware of the risks associated with the envisaged commitment or investment;
- whose expertise, experience and knowledge were assessed by the AIFM;
- regarding whom the AIFM is sufficiently convinced that he is capable of making his own investment decisions and understanding the risks involved and that such a commitment is appropriate for the respective investor; and
- to whom the AIFM confirms in writing that it has made the assessment mentioned above and the prerequisites regarding the investor’s capabilities in relation to the intended commitment are fulfilled.

Furthermore, directors and employees of the AIFM who invest in a fund managed by the AIFM, as well as 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, single manager hedge funds however may not be marketed to retail investors.

### 32. Are there additional restrictions on marketing to government entities or pensions?

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, any 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 licence 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 requirements. Adherence to certain ESG standards has also been a recent trend. Certain regulated investors require free transferability of their interests and certain disclosure commitments from the manager.

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