Impractical requirements

The niche for unregulated funds is becoming smaller. Uwe Bärenz and Sebastian Käpplinger of P+P Pöllath + Partners in Berlin provide an overview of the new license requirement for investment management

In March 2009, the German legislator introduced a new licence requirement for unregulated investment funds and vehicles. The purchase and sale of financial instruments with discretion for a group of individuals now requires a licence for investment management (Anlageverwaltung) under the German Banking Act (Kreditwesengesetz). But a licence is only necessary if further requirements are met. The purchase and sale of financial instruments must constitute the focus of the activity. Further, the activity must be directed at investors' participation in the performance of the financial instruments.

Oversight amendment

The amendment changes the regulatory oversight on investment schemes in Germany. Before the new law, the Investment Act (Investmentgesetz) mainly imposed strict regulatory licence and operational requirements on the management of investment schemes. In addition, securities laws have always been applicable. But the Investment Act's requirements extended, and continue to extend, only to certain types of investment schemes that are more or less clearly defined in the Investment Act.

As a result, at least in theory, one could set up investment schemes outside the Investment Act with very little ongoing regulatory oversight. This lack of supervision prompted the German Financial Supervisory Authority (BaFin) in recent years to revert to the Banking Act. The Banking Act requires a licence for certain types of banking and financial services, such as portfolio management or financial commission. BaFin tried to invoke these licence requirements to extend its reach to unregulated investment schemes.

In one recent case, however, the German Federal Administrative Court (BVerwG) rejected BaFin's use of the Banking Act. In this case, a corporation (Gamag) issued notes indexed to the performance of financial instruments. Gamag purchased and sold these financial instruments on its own account and made payments under the notes pursuant to the index.

BaFin argued that Gamag performed, among others, financial commissions, and therefore required a licence under the Banking Act. A financial commission is defined as the purchase and sale of financial instruments in one's own name, but on account of a client. In its wording and history, the definition is based on the commission of goods and instruments as defined in the German Commercial Code (Handelsgesetzbuch). The Commercial Code describes the commission of goods and instruments with specific characteristics, such as the duty of the broker to deliver the goods and instruments to its client.

In the absence of Gamag's duty to deliver the financial instruments to the noteholders, BaFin argued, financial commission should instead be understood in an economic sense. So the noteholders' participation in the performance of the traded instruments via the index-linked notes, according to BaFin, fulfils the definition of a financial commission. BVerwG rejected such economic interpretation of the Banking Act's financial commission. In its wording and history, a financial commission is based on the Commercial Code's commission of goods and instruments and must be understood accordingly.

Despite or because of this drawback in the courts, the Federal administration reacted swiftly. A draft bill appeared shortly thereafter. It was strongly criticised for its lack of focus and was replaced by a new, more restrictive wording similar to the currently valid wording described above.

The new licence requirement aims to provide a clearer legal basis for BaFin's powers over previously unregulated investment funds and vehicles. At the same time, such investment schemes are exempt,

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for which neither investor protection nor the integrity of the financial markets demands regulatory supervision. BaFin issued a preliminary letter ruling based mainly on the lawmaker comments in the draft bill. It announced the release of a more detailed letter ruling soon. Accordingly, the requirements for investment management are still quite vague.

Purchase and sale

First and foremost, investment management necessitates the purchase and sale of financial instruments. Financial instruments are tradable and fungible instruments such as stocks, notes, investment fund units or certain derivatives. In contrast, partnership interests are usually not considered financial instruments as they lack tradability and fungibilty.

It is still unclear whether the investment management's requirement of purchasing and selling financial instruments embraces only trading activities, or whether it also extends to the purchase and holding of financial instruments for a longer period. The latter activity is typical for private equity funds; they acquire instruments in companies and exit them after some time has passed.

The wording of the new licence requirement and its similarity to other regulated trading activities suggests a trading requirement as well. Furthermore, the comments in the draft bill hint at aiming to regulate trading activities. In particular, the law expressly aims to regulate a vehicle's activity only if investor protection and the integrity of the financial markets necessitate a licence. As such, the purchase of financial instruments and disposal of them only after a longer period has passed poses less risk to investors and financial markets as ongoing trading activities. However, it is still an open question whether BaFin will follow this trade-orientated approach.

Discretion in selecting financial instruments

The purchase and sale of financial instruments will only fall within the realm of a licensed activity if there is discretion in selecting the financial instruments. For interpreting discretion in the context of investment management, it is helpful to revert to another licensed activity: portfolio management. Portfolio management also embraces discretion as a key element. It is therefore possible to conclude how investment management's discretion is likely to be interpreted by BaFin. Similar to portfolio management, discretion as to investment management may be lacking if investors would have to approve any decision to sell or purchase financial instruments. In contrast, discretion sufficient for investment management exists if investors can, in general, give orders only for certain trading decisions. The mere existence of investor rights in corporate articles or partnership law to give orders to the management is not sufficient to eliminate discretion for purposes of the new licence requirement.

As well as referring to discretion as interpreted with regard to portfolio management, the interpretation must consider the specific legal requirements of investment management. Pursuant to this wording, discretion only matters from a regulatory perspective if it exists with regard to selecting financial instruments. Discretion will not cause the activity to fall within the Banking Act if it is given only with regard to the timing and conditions of a purchase or sale of financial instruments.

"The new license requirement remains particularly unclear in one- or multiple-tier investment structures"

Group of individuals

The purchase and sale of financial instruments constitutes investment management only if it is performed for a group of individuals. Unfortunately, this requirement is the most vague. In its broadest description, an activity is performed for a group of individuals if the individuals bear the material benefits and losses of the activity. This requires some further clarification.

The new licence requirement aims to protect private, individual investors. The investor group must therefore consist of individuals and not merely of entities or other institutional investors.

What the term group means in this context is not quite clear. But it is clear that investment management wants to regulate investment vehicles regardless of how investors are linked to the vehicle. On the other hand, the wording of the licence requirement limits the interpretation. The German term group more closely translates to community (Gemeinschaft). As a community, investors must have something in common. One of these common elements should be the key terms with regard to the participation in the financial instruments (the terms and conditions of a note).

Acting for the group

The requirement of purchasing and selling financial instruments for a group of individuals remains particularly unclear in one- or multiple-tier investment entity structures. As mentioned above, an activity is performed for a group of individuals if the individuals bear the

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material benefits and losses of the activity. The lawmakers intended this language to include the participation of individuals in trading activities through entities, no matter how the individuals are linked to the performance of the financial instruments. Therefore, performing for a group of individuals means ignoring the entity structures. From this perspective, the Gamag case would have been decided differently.

Gamag would have conducted investment management despite being a separate legal entity from the investor noteholder. The index-linked investor participation in the performance of the financial instruments purchased and sold by Gamag would now suffice to bring the activity under the scope of the Banking Act.

This approach of ignoring the entity structures might work well in one-tier structures, but causes problems in multi-tier structures. For example, a fund-of-fund with private German residents as investors invests in one or more opportunity funds. The opportunity funds purchase and sell financial instruments as they see fit. If you ignore the structure, the structure's activity might be categorised as investment management under the Banking Act.

This creates concerns for both the fund-of-fund, as well as for the opportunity funds. First, a foreign domicile does not necessarily shield a fund from the German Banking Act. The German Banking Act also applies to foreign banking and financial service providers without any branches or representative offices in Germany, if investors are specifically targeted within Germany.

Both the fund-of-fund as well as the opportunity funds might require licences under the German Banking Act. It is unclear how to deal with this potential double-licence situation. According to a general principle of German administrative and constitutional law, if different persons are subject to a duty under an administrative statute, the administrative agency can only exert its powers over the person that directly violates the law. This is designed to protect people acting in accordance with the law from government powers even if their acts, through the interference of a third person, ultimately lead to a violation of law. Thus, the agency could only get the fund-of-fund to obtain a licence and the opportunity funds should be safe. It is still unclear whether BaFin will apply this approach to investment management. For the time being, foreign funds should make sure that they do not seek to service individuals resident in Germany, for instance by getting corresponding representations in the subscription agreements.

If the fund-of-fund falls under the licence requirement for investment management, it might still argue its way out of a licence. After all, it does not perform one element of investment management: the discretional purchase and sale of financial instruments. This is solely done by the opportunity funds. However, BaFin already asserted that it would impute activities performed by other persons if they willingly and consciously work together, which is unfortunately a very broad definition. One can hope that BaFin will restrict the imputation to cases in which the fund-of-fund (or other vehicle in question) can actually influence the operative vehicle.

Focus and investor participation

The Banking Act will only require a licence for investment management if the purchase and sale of financial instruments constitutes the focus of the product. The activity must also be directed at investors' participation in the performance of the financial instruments. These two elements filter out structures that carry a risk for participants different from a trading activity in financial instruments.

But the statute and lawmakers' materials are not quite clear on when an activity crosses the threshold to become a focus activity. It seems the relative value of the financial instruments purchased and sold is only one aspect to consider. The lawmaker comments in the draft bill also refer to the advertisement of the product. Risk associated with the trading should also be considered. The lower the risk, the less an associated activity will be the focus of the product and vice versa. In the end, one must look at the whole product to decide whether the purchase and sale of financial instruments constitutes the product's focus. As an example, auxiliary trading in derivatives might be fine only if strictly limited and controlled. Also, the parking of liquidity in money market instruments should not be considered a focus activity.

The purchase and sale of financial instruments will only be considered investment management if the activity is directed at investors' participation in the performance of the financial instruments. This proviso is designed to exempt private equity funds from the new licence requirement. A private equity fund's purpose is to improve the business of its target companies by exerting control over its management. Therefore, investors in private equity funds do not carry risk associated with financial instruments (if the target company holdings are financial instruments at all). Rather, investors participate in the performance of the target companies' business. They bear a business risk, not a trading risk.

A specific exemption applies to funds whose units qualify as units in foreign investment funds pursuant to the Investment Act. In general, the Investment Act applies to the distribution of such units only if distributed by public placement. Units in foreign investment funds (with the exception of units in single hedge funds) can therefore be distributed by private placement in Germany without triggering the Investment Act's regulatory threshold. So there would be room to apply the Banking Act to such funds, in particular the new investment management licence requirement. However, foreign investment funds can rely on an exemption in the Banking Act. They are not subject to the licence requirement for investment management, regardless of whether they are distributed by private or public placement.

The new licence requirement for investment schemes in the Banking Act is very broadly defined. Accordingly, there is a risk that certain investment structures will fall within the scope of the licence requirement even though they are not the intended targets of the new regulation. Thus far, BaFin has issued only a preliminary letter ruling with little guidance and announced a more detailed letter ruling to be issued at a later date. BaFin should recognise the overreach of the licence requirement and come up with some practical limitations.

About the author

Sebastian Käpplinger specialises in structuring private equity funds, as well as other alternative investments. He is admitted to the bar in Berlin and New York. After having studied law at Humboldt University at Berlin, he earned a master's degree from Penn State University's Dickinson School of Law and a PhD from the University of Hamburg.

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