Simmons & Simmons

Newsletter

The New Capital Investment Circular

January 2018

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1. Introduction

On 12 December 2017, the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – *"***BaFin***"*) published the new Capital Investment Circular 11/2017 ("**Capital Investment Circular**"). The Capital Investment Circular provides an interpretation of the legal basis for the supervision of insurance companies in connection with the capital investment of primary insurers to which the provisions of sec. 212 to 217 of the Insurance Supervision Law *(Versicherungsaufsichtsgesetz* –"**VAG**") apply (so-called "**Small Insurance Companies**") as well as of pension schemes and pension funds. Furthermore, the Capital Investment Circular has practical relevance to occupational pension schemes and other asset managers that are guided by the regulations for the supervision of insurance companies in their investment activities.

Concerning the background: On 3 March 2015, the ordinance on the investment of the guarantee assets (*Sicherungsvermögen*) of pension schemes', burial funds' and small insurance companies' was amended. Thus, the ordinance was adapted to the Capital Investment Code *(Kapitalanlagegesetzbuch* – "**KAGB***")* and extended by further investment opportunities in the field of infrastructure. The contents of the current version of the Investment Ordinance dated 18 April 2016 *(Anlageverordnung* – "**AnlV***")* are essentially identical to those of the investment ordinance as amended on 3 March 2015.

After the amendment to the AnlV, the previous capital investment circular from 2011 ("**Circular 4/2011**") was only significant to a limited extent. This is why especially the reasoning behind the investment ordinance from 2015 ("**Ordinance Reasoning**") was subsequently used for the interpretation of the AnlV.

On 21 December 2016, BaFin submitted a new draft capital investment circular for consultation ("**Draft for Consultation**"). This draft deviated from the Ordinance Reasoning in some respects.

In this newsletter, we would like to provide an outline of the material changes by the Capital Investment Circular with regard to the investments in alternative investment funds ("**AIF**") held by German regulated investors.

2. Outline

- The Capital Investment Circular 11/2017 serves to interpret the Investment Ordinance and replaces Circular 4/2011.
- As far as assessing the eligibility of a private-equity fund-of-funds ("**FOF**") is concerned, the regulatory requirements generally only apply at the level of the FOF and not at the level of each individual target fund. In order to satisfy the ban on circumvention, it must be ensured that the target funds invest in participations in enterprises and, in doing so, take entrepreneurial risks.
- Concerning private-equity FOF, the fact that the short-term debt financing at the level of the FOF is limited to 10% of the fund's value is new.
- Pursuant to sec. 2 para. 1 no. 16 AnlV, private-equity funds are eligible in the form of securities or participations in enterprises as assets for a special fund.
- When it comes to assessing the eligibility of other funds pursuant to sec. 2 para. 1 no. 17 AnlV, the target funds must also be able to be acquired for the guarantee assets.to qualify pursuant to sec. 2 para. 1 no. 17 AnlV.

3. Material changes by the Capital Investment Circular

In the following, you will find an outline of the material changes made by the Capital Investment Circular with regard to the eligibility of AIF:

- Private-equity funds pursuant to sec. 2 para. 1 no. 13 b) AnlV (clause 3.1);
- Real-estate funds pursuant to sec. 2 para. 1 no. 14 c) AnlV (clause 3.2);
- Special funds pursuant to sec. 2 para. 1 no. 16 AnlV (clause 3.3);
- Other funds pursuant to sec. 2 para. 1 no. 17 AnlV (clause 3.4); and
- Debt funds (clause 3.5).

To a large extent, these changes were already provided for in the Draft for Consultation.

3.1 Private-equity funds (sec. 2 para. 1 no. 13 b) AnlV)

Closed-ended private-equity funds can be acquired for the guarantee assets as indirect investments in participations in enterprises pursuant to sec. 2 para. 1 no. 13 b) AnlV. The private-equity fund must

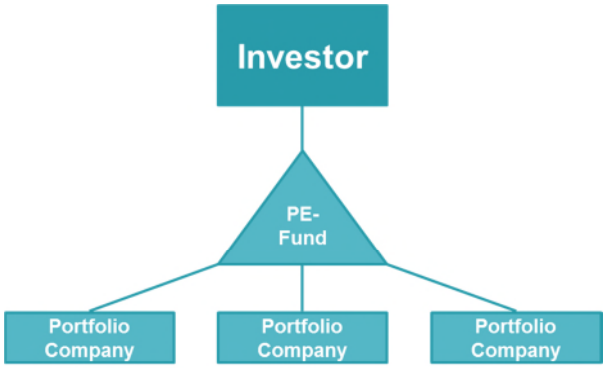
- be managed by an asset management company that has a permit pursuant to sec. 20 para. 1 KAGB or is registered pursuant to sec. 44 KAGB, or
- be managed by a management company established in an EEA state or in a full OECD member state that is subject to public supervision to protect the investors and has a permit comparable to the permit pursuant to sec. 20 para. 1 KAGB or a registration comparable to the registration pursuant to sec. 44 KAGB.

This also applies to foreign private-equity funds that are subject to the jurisdiction of an EEA or an OECD state.

In particular, concerning private-equity funds, the Capital Investment Circular raises questions relating to debt financing and the look-through approach of FOF structures.

3.1.1. Debt capital employed at the level of individual funds

The following refers to the level of individual funds, i.e. funds that directly or indirectly invest in portfolio companies, but not in other funds.



The Draft for Consultation permitted short-term debt financing in the amount of 10% (without reference to the basis) at fund level.

As the employment of leverage, i.e. the employment of debt capital for the purpose of increasing exposure, was not explicitly mentioned in this context, it is assumed that the employment of leverage should no longer be permitted at the level of the fund.

This would have meant a considerable tightening of the previous administrative practice, as debt financing by private-equity funds had previously not been limited. The exclusion of leverage at fund level would have disregarded the present market practice and would have triggered further problems; for instance, it would have been necessary to specifically define when leverage is employed at the level of the portfolio or acquiring companies and when the employment of debt capital for leverage purposes is to be allocated to the fund.

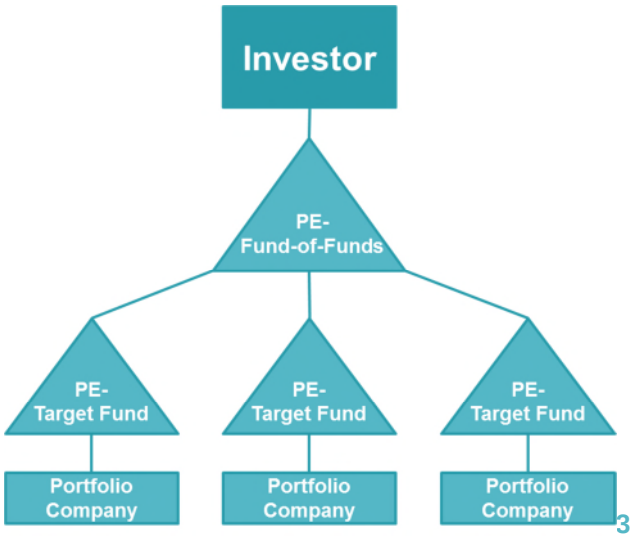
The Capital Investment Circular now seems to do without these limitations. Under clause B.4.9 b) of the Capital Investment Circular, debt financing is generally permitted, in particular for pre-financing capital calls at the level of the individual funds.

Although BaFin mentions entering into short-term liabilities as an example, the use of the term “especially” provides that debt financing can still also occur for other purposes, including leverage. This is in line with BaFin’s administrative practice to date. At an individual level, private-equity funds may therefore

- take on debt financing; and
- employ the debt capital for leverage purposes.

3.1.2 Look-through approach in a private-equity FOF structure

The following refers to a private-equity FOF structure.



In respect of private-equity FOFs, it is debatable whether the eligibility requirements of the AnlV must also exist at the level of the target funds. This especially concerns the requirements for the supervision of the management companies, the employment of debt capital at the level of the private-equity target funds and the target assets qualifying as participations in enterprises.

Registration of the management company pursuant to sec. 44 KAGB (or being regulated in an EEA or OECD state) and taking entrepreneurial risks through the target holding company is a minimum prerequisite for the fund to be allocated to the participation quota in accordance with sec. 2 para. 1 no. 13 b) AnlV.

Due to the relatively low requirements compared to other investment categories concerning alternative investment funds, BaFin uses the Capital Investment Circular to emphasize that the Investment Ordinance may not be circumvented, i.e. investments that would otherwise not be suitable or that are allocated to other risk categories may not be re-packaged as holding within the meaning of sec. 2 para. 1 no. 13 b) AnlV.

In clause B.4.9 b) of the Capital Investment Circular, BaFin states that the requirements under number 13 b) may also not be circumvented in the case of an investment in the target fund. Furthermore, BaFin points out that "*for instance, interests and shares in securities, real-estate or hedge funds do not qualify as target funds under number 13 b) for the guarantee assets*".

It is debatable whether it must be concluded from this that all requirements set forth by sec. 2 para. 1 no. 13 b) AnlV and by the Capital Investment Circular also need to be fulfilled at target fund level (so-called look-through).

With a look-through approach, problems would arise both in respect to regulation requirements and concerning the limitation of debt financing:

- As far as the registration of the asset management company in an EEA state or in a full OECD member state is concerned, the Capital Investment Circular sets forth that the (asset) management companies managing the private-equity target funds can also be established outside the OECD (cf. clause B.4.9 b) of the Capital Investment Circular), which is in line with the provisions on interpretation relating to sec. 2 para. 1 no. 13 a) AnlV. However, at this point, the Capital Investment Circular fails to mention whether the further regulatory requirements, viz. that (comparable) public supervision and a (comparable) permit or registration of the foreign management company are in place, must also be fulfilled. If this were the case, in practice, it would no longer be possible to (indirectly) acquire private-equity target funds established outside the EEA as participation (pursuant to sec. 2 para. 1 no. 13 b) AnlV) because public supervision and/or a permit or registration of the management company are in many cases not in place. While it would also be possible for such company to be supervised and registered in a full member state of the OECD, generally it will prove difficult to argue a comparability with the requirements of the AIFMD[1] if the OECD member states are not concurrently part of the EU or the EEA.
- According to the Capital Investment Circular, the following applies concerning the employment of debt financing: At the level of the FOF, short-term debt financing in the amount of up to 10% of the "AIF's value" is generally permitted (cf. clause B.4.9 b) of the Capital Investment Circular). This should exclude leverage investment at FOF level. At target fund level, however, leverage investment should be permitted (see clause 3.1.1 above) – even in the case of a look-through approach. The reference to the "AIF's value" should – similar to real-estate funds and special funds – represent an adaptation to the KAGB. The "AIF's value" as specified in the KAGB means the net asset value, i.e. the sum of the corresponding market values of the assets pertaining to the AIF minus the loans taken out and any other liabilities (cf. sec. 168 para. 1 sent. 2 KAGB;

[1] Directive 2011/61/EU dated 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No. 1060/2009 and (EU) No. 1095/2010.

see also the statement on the government's bill for the act implementing the UCITS Directive, *Bundesverband Sachwerte und Investmentvermögen*, 7 January 2016, p. 9).

To require a look-through approach under the Capital Investment Circular would, however, contradict the Ordinance Reasoning. According to the Ordinance Reasoning, if private-equity funds are invested in via FOF, the target funds explicitly do not have to qualify pursuant to sec. 2 para. 1 no. 13 b) AnlV (cf. p. 4 of the Ordinance Reasoning).

The Ordinance Reasoning allows for the supervisory authority to determine more specific regulatory requirements by way of a circular in order to address potential circumvention risks that can be incidental to investments in FOF (cf. p. 4 of the Ordinance Reasoning). And yet, after ordering a target-fund-level look-through approach in the original reasoning for the Investment Ordinance dated 23 May 2014 ("**2014 Ordinance Reasoning**"), the legislator explicitly distanced itself from this view by stating that target funds need not be qualified pursuant to number 13 b) in the case of an investment via FOF. Therefore, in interpreting the AnlV, it is reasonable to infer that BaFin feels bound to the guiding principles established by the legislator.

Also, within the scope of numbers 16 and 17, BaFin explicitly requires a look-through approach (clauses B.4.13 and B.4.14 of the Capital Investment Circular). In the section dealing with private-equity funds, however, BaFin have quite rightly refrained from stipulating such a specific requirement.

In order to address the risk of circumvention, as was provided by the Ordinance Reasoning, it must be ensured that target funds directly or indirectly invest in holdings in non-listed companies, instruments akin to equity or other business financing instruments. Thus, it is a prerequisite that the target funds take entrepreneurial risks through their target holding companies.

3.2 Real-estate funds (section (2)(1)(14)(c) AnlV)

3.2.1 General requirements

Sec. 2 para. 1 no. 14 c) AnlV specifies the viable routes for investing the guarantee assets in real estate by way of acquiring interests and shares in AIF investing in real estate.

In addition to stipulating the requirement for a regulated asset management company, sec. 2 para. 1 no. 14 c) AnlV provides for a *numerus clausus* for the assets eligible for the real estate AIF. Thus, it may directly or indirectly only invest in assets as specified in sec. 231 para. 1 sent. 1 no. 1 to 6 KAGB or in real-estate companies as specified in sec. 235 para. 1 KAGB. Furthermore, according to the Capital Investment Circular, liquidity assets are permitted, provided they roughly fulfil the requirements under sec. 253 para. 1 KAGB. Concerning these general requirements, the Capital Investment Circular does not yield any innovations compared to the previous interpretation under Circular 4/2011.

3.2.2 Debt financing at the level of individual funds and FOF

At the level of individual funds, where real-estate funds are concerned, the Capital Investment Circular provides that long-term debt financing is only possible up to the amount of 60% of the market value of the AIF's real-estate portfolio. Short-term debt financing must be limited to a maximum of 30% of the AIF's value.

Concerning real-estate FOF structures, the Draft for Consultation only allows for short-term debt financing up to 30% of the asset value at the level of the real-estate FOF. Therefore, the wording of the Draft for Consultation already inferred that long-term debt financing – as well

as the employment of leverage at FOF level – be excluded (cf. clause B.4.10 of the **D**raft for Consultation).

In principle, the Capital Investment Circular adopted these changes. However, the reference used in the limitation on short-term debt financing is no longer the "asset value", but the "AIF's value". Both the AIF's value and the asset value are likely to mean the fund's net asset value as specified by the KAGB. This is probably an adaptation to the KAGB (please also see above in this regard). Contrary to this, as far as long-term debt financing at the level of individual funds is concerned, the gross asset value, i.e. the market value of the real-estate portfolio, is still used as a basis.

3.3 Acquisition of closed-ended (target) funds by special funds (section (2)(1)(16) AnlV)

Pursuant to sec. 2 para. 1 no. 16 AnlV, it is possible to acquire interests and shares in German open-ended special AIF within the meaning of sec. 1 para. 6 sent. 1 KAGB that fulfil the requirements set out under section 284 KAGB (special AIF with fixed terms of investment) and do not fall under sec. 2 para. 1 no. 14 c) AnlV. In addition, the special fund must be managed by an asset management company that has a permit pursuant to sec. 20 para. 1 KAGB or by a management company established in an EEA state that is subject to public supervision and has a permit comparable to the permit pursuant to sec. 20 para. 1 KAGB designed to protect investors.

3.3.1 Eligible assets as specified by the KAGB and the Capital Investment Circular

For quite some time, BaFin has been placing stricter requirements on eligible assets than those set out by the AnlV by referring to the KAGB. The following table compares the eligible assets and/or eligibility requirements for a special AIF with fixed terms of investment as set out in sec. 284 para. 2 no. 2 KAGB and for a special fund as specified under clause B.4.13 of the Capital Investment Circular:

Pursuant to sec. 284 para. 2 no. 2 KAGB the following assets are eligible for a special AIF with fixed terms of investment:	**In the Capital Investment Circular, BaFin places further requirements – exceeding sec. 284 para. 2 no. 2 KAGB – on the assets eligible by a special fund (hereinafter allocated to the assets of sec. 284 para. 2 no. 2 KAGB):**
• Securities (sec. 284 para. 2 no. 2 a) KAGB);	• Securities may only be in accordance with sec. 193 KAGB (clause B.4.13 i); • Other investment instruments pursuant to sec. 198 no. 1 KAGB are limited to an amount of up to 20%, other investment instruments pursuant to sec. 198 no. 1 to 4 KAGB are limited to a total amount of up to 30% of the AIF's value (clause B.4.13 iii);
• Money market instruments (sec. 284 para. 2 no. 2 b) KAGB);	• No further requirements;

• Derivatives (sec. 284 para. 2 no. 2 c) KAGB);	• Derivatives may only be invested in accordance with sec. 197 para. 1 and 2 KAGB (clause B.4.13 ii);
• Credit balance with a bank (sec. 284 para. 2 no. 2 d) KAGB);	• No further requirements;
• Real estate (sec. 284 para. 2 no. 2 e) KAGB);	• Real estate may only be acquired pursuant to sec. 231 para. 1 sent. 1 no. 1 to 6 and sec. 235 para. 1 KAGB and, together with interests and shares in real-estate funds as specified under sec. 2 para. 1 no. 14 c) AnlV, must be limited to an amount of up to 49% of the AIF's value (clause B.4.13 vi);
• Holdings in real-estate companies (sec. 284 para. 2 no. 2 f) KAGB);	• No further requirements;
• Interests or shares in national open-ended AIF as well as in corresponding open-ended EU or international AIF (sec. 284 para. 2 no. 2 g) KAGB);	• Interests and shares in open-ended target funds that fulfil the requirements set out under sec. 2 para. 1 no. 17 AnlV must be limited to an amount of up to 49% of the AIF's value (clause B.4.13 vii); • Target funds must also be open-ended and qualify for the guarantee assets (clause B.4.13 x);
• Holdings in PPP project companies if the market value of these holdings can be calculated (sec. 284 para. 2 no. 2 h) KAGB); and	• No further requirements;
• Precious metals, non-securitized claims for repayment of a loan and participations in enterprises if the market value of these participations can be calculated (sec. 284 para. 2 no. 2 i) KAGB).	• Precious metals must be limited to an amount of up to 30% of the AIF's value (clause B.4.13 ix); • Non-securitized claims for repayment of a loan pursuant to sec. 221 para. 1 no. 4 KAGB must be limited to an amount of up to 30% of the AIF's value (clause B.4.13 iv); and • Participations in enterprises that are not admitted for trade on a stock market or involved in an organized market, including interests and shares in closed-ended private-equity funds as specified under sec. 2 para. 1 no. 13 b) AnlV (limited to an amount of up to 20% of the AIF's value) (clause B.4.13 xi).

	Furthermore, the following requirements apply: • Securities lending and borrowing transactions must fulfil the requirements set out under sec. 200 to 202 KAGB with regard to the collateral provided (clause B.4.13 v); and • a distribution in kind, in particular a physical delivery of precious metals, must be concluded (clause B.4.13 viii).

3.3.2 Eligibility of interests in closed-ended funds

Pursuant to the KAGB, it is possible to acquire interests in closed-ended funds either as securities as specified under sec. 284 para. 2 no. 2 a) KAGB in connection with sec.193 para. 1 no. 7 KAGB or as participations in enterprises as specified under sec. 284 para. 2 no. 2 i) KAGB.

An AIF, by definition, should not engage in entrepreneurial activities (cf. sec. 1 para. 1 sent. 1 KAGB). Therefore, as regards, the acquisition of participations in enterprises, it has been discussed to date whether a closed-ended fund as an AIF is excluded from simultaneously qualifying as an enterprise. However, in the Capital Investment Circular, BaFin has set out that this is not the case as participations in enterprises shall specifically include interests in closed-ended private-equity funds within the meaning of sec. 2 para. 1 no. 13 b) AnlV (cf. clause B.4.13 xi) of the Capital Investment Circular). Therefore, other funds ultimately investing in participations in enterprises (such as infrastructure funds, for example) should be eligible as participations in enterprises for special funds pursuant to sec. 2 para. 1 no. 16 AnlV.

With regard to the eligibility of units in closed-ended investment funds as security within the meaning of sec. 193 para. 1 no. 7 KAGB, whether an allocation to sec. 193 para. 1 no. 7 KAGB is still possible is unclear as clause B.4.13 x) of the Capital Investment Circular determines that target funds must be open-ended.

In support of such interpretation, it may be argued that the requirement for target funds to be open-ended would not have any own regulatory content if it did not overrule sec. 193 para. 1 no. 7 KAGB. Other than qualifying as security or participation in an enterprise, the only eligible asset class under sec. 284 para. 2 no. 2 g) KAGB for investment funds is the category of open-ended investment funds.

Arguably, the following aspects should be taken into account against the exclusion of sec. 193 para. 1 no. 7 KAGB:

- Pursuant to BaFin's wording, all securities under sec. 193 KAGB are eligible. BaFin had the opportunity to exclude sec. 193 para. 1 no. 7 KAGB from its guidance provided in clause B.4.13 i) of the Capital Investment Circular, but it chose not to use this option;
- BaFin determines that securities acquired for a special investment fund must comply with the requirements in sec. 193 KAGB (so-called narrow concept of the term security). In the same context, however, BaFin states that securities may also be eligible for a special investment fund if they comply with the requirements in sec. 198 no. 1 KAGB (so-called extended concept of the term security), although only up to a limit of 20% of the investment fund's value. Securities within the meaning of sec. 198

no. 1 KAGB are also securities which are not listed on a stock exchange, as in the case of closed-ended funds that qualify as securities pursuant to sec. 193 para. 1 no. 7 KAGB, and comply with the core requirements of art. 2 para. 1 Directive 2007/16/EC. The fact that BaFin not only accepts securities under sec. 193 KAGB but also refers to securities pursuant to sec. 198 no. 1 KAGB suggests that BaFin requiring target funds to be open-ended merely reiterates a requirement for open-ended investment funds for the asset category of investment funds pursuant to sec. 284 para. 2 no. 2 g) KAGB rather than excluding the more specific provision of sec. 193 para. 1 no. 7 KAGB.

- BaFin allows the acquisition of closed-ended private-equity funds under the more specific asset category of participations in enterprises. Therefore, the – general – provision pursuant to which target funds must be open-ended probably does not refer to the eligibility of asset categories other than German investment funds pursuant to sec. 284 para. 2 no. 2 g) KAGB.

- Sec. 193 para. 1 no.1 to 4 KAGB refer to securities listed on a stock exchange or whose listing can be reasonably anticipated. Securities pursuant to sec. 193 para. 1 no. 7 KAGB present an extension of the spectrum of securities eligible under sec. 193 KAGB. Pursuant to sec. 193 para. 1 no. 7 KAGB, units in closed-ended investment funds are eligible for UCITS if they comply with the requirements pursuant to Art. 2 para. 2 lit. a) and b) of Directive 2007/16/EC (see CESR Advice to the European Commission on Clarification of Definitions concerning Eligible Assets for Investments of UCITs, January 2006 (Ref: CESR/06-005), page 13). The requirements for closed-ended investment funds pursuant to sec. 193 para. 1 no. 7 KAGB therefore reach such a degree of sophistication that a risk of circumvention of the requirement for target funds to be open-ended is not conceivable. Assuming that the requirement for target funds to be open-ended applies to every asset category of eligible investment funds under sec. 284 para. 2 no. 2 KAGB, one could argue that BaFin introduced this requirement to ensure that an investor is able to provide an effective liquidity management due to the effective redemption procedures granted to investors by open-ended investment funds. With regard to sec.193 para. 1 no. 7 KAGB, the effectiveness of the investor's liquidity management is already ensured as the investor has to establish that an investment in the closed-ended fund does not adversely affect the investor's liquidity (Art. 2 para. 2 a) i) in conjunction with para. 1 b) Direction 2007/16/EC); and

- it would not be a singular case if BaFin includes mere declaratory provisions which do not provide any regulatory content beyond the provisions set-out in the AnlV in conjunction with the KAGB, e.g. the 20% limitation on non-listed participations (see clause B.4.13 xi) of the Capital Investment Circular) which can already be derived from sec. 284 para. 3 KAGB.

Furthermore, it is questionable whether the qualification of a closed-ended investment fund as security pursuant to sec. 193 para. 1 no. 7 KAGB may be considered a circumvention of the 20% limitation which applies if a closed-ended private-equity fund qualifies as a participation in an enterprise (see clause B.4.13 (xi) of the Capital Investment Circular). BaFin does not address this conflict.

The 20% limitation on participations in enterprises, i.e. the acquisition of securities issued by non-listed companies, addresses the fact that participations convey a higher risk than standardized financial products which qualify as securities and are, therefore, liquid and fungible.

Sec. 193 para. 1 KAGB refers to listed securities and securities considered to be equivalent to listed securities (see above). In contrast to a participation in an enterprise, a closed-ended investment fund, which qualifies as a security pursuant to sec. 193 para. 1 no. 7 KAGB can, therefore, be considered to provide a degree of safety comparable to that of a listing. Consequently, a limitation is not necessary and does not constitute a circumvention with regard to the 20% limitation.

As a result, closed-ended investment funds pursuant to sec. 2 para. 1 no. 13 b) AnlV should continue to be eligible for a special fund under sec. 2 para. 1 no. 16 AnlV as a security pursuant to sec. 193 para. 1 no. 7 KAGB (without limitation) or as a participation in enterprises (subject to a 20% limitation of the investment fund's value).

3.4. Look-through with regard to other investment funds (Sec. 2 para. 1 no. 17 AnlV)

Sec. 2 para. 1 no. 17 AnlV provides that any AIF which is not a private-equity-fund, real estate fund, special fund or UCITS is eligible for the pool of restricted assets provided the AIF complies with the requirements of no. 17 AnlV.

A significant amendment introduced by the Draft for Consultation affects the acquisition of target funds: If an investment fund pursuant to sec. 2 para. 1 no. 17 AnlV invests in target funds, the target funds must also be directly eligible for the guarantee assets under the AnlV. This requires that the respective target fund is managed by a management company resident in the EEA (and, in the case of private-equity funds, in the OECD) and subject to public regulation and in possession of a (comparable) license or registration. An exemption was made for hedge fund of funds: In case of hedge fund of funds, the target funds may also be resident outside the EEA if the target fund is also a hedge fund and complies with requirements comparable to those set out in sec. 283 KAGB (clause B.4.14 of the Capital Investment Circular).

As this amendment survived the consultation process and was included in the final circular, it is conceivable that non-regulated target funds which do not qualify as hedge fund of funds or which are otherwise not directly eligible are no longer eligible as indirect investments in the context of FOF structures under no. 17 AnlV. For instance, an indirect investment in US loan funds, as far as the loan fund cannot be allocated to sec. 2 para. 1 no. 13 b) AnlV, is likely no longer possible under no. 17 AnlV. However, the option remains to acquire such an investment using the escape clause (*Öffnungsklausel*) or the structuring of parallel funds which comply with the regulatory requirements.

The application of the look-through approach in respect of FOF structures under number 17 AnlV is unfortunate and – in our view – also unnecessary. Moreover, it contradicts the intention of the legislator expressed in the systematic of the AnlV.

Investments in other investment funds pursuant to number 17 AnlV, together with investments in hedge funds and commodities are limited to 7.5% of the guarantee assets (sec. 3 para. 2 no. 2 AnlV). With specific reference to this limitation, the legislator has omitted the introduction of further requirements with regard to investments under number 17 AnlV, although the legislator was aware of the risks involved in the extension of investment opportunities (sec. 3 para. 2 no. 2 AnlV and page 6 of the Ordinance Reasoning).

3.5. Loan funds

Depending on the structure of the respective loan fund, the eligibility of interests in loan funds is conceivable under various asset categories of the AnlV.

Loan funds may be qualified as private-equity funds pursuant to sec. 2 para. 1 no. 13 b) AnlV, according to which investments in closed-ended funds are eligible particularly if these funds invest in instruments of corporate financing. For example, pursuant to the Capital Investment Circular, claims from subordinated liabilities qualify as instruments of corporate financing. However, the mere passive holding of loans in private-equity funds is still not permitted. The allocation to sec. 2 para. 1 no. 13 b) AnlV, therefore, requires that, beyond the origination of a loan, the fund has to conduct its own due diligence in the course of the origination process and must monitor the further development of the loan (clause B.4.9 b) Capital Investment Circular).

A second option is the qualification of a loan fund as a special fund pursuant to sec. 2 para. 1 no. 16 AnlV. However, pursuant to clause B.4.13 iv) of the Capital Investment Circular, unsecuritised loans are limited to 30% of the investment fund's value and, therefore, mere loan funds cannot be acquired under no. 16 AnlV.

The third and final option is the allocation to sec. 2 para. 1 no. 17 AnlV because neither stricter requirements exist under number 17 AnlV with regard to the loan origination and administration nor do any limitations with regard to unsecuritised loans. Therefore, it is possible to invest 100% in unsecuritised loans under number 17 AnlV (see page 6 of the Ordinance Reasoning).

However, number 17 AnlV requires that both the loan fund and the target fund (if any) are managed by a management company resident in the EEA (and, in the case of a private-equity target fund, in the OECD), and subject to a public regulation and in possession of a (comparable) license or registration. An indirect investment under no. 17 AnlV, particularly in US loan funds which do not qualify as private-equity funds, should no longer be possible pursuant to the Capital Investment Circular (see above).

3.6. The 1%-limitation

Pursuant to sec. 4 para. 4 sent. 1 AnlV, investments pursuant to sec. 2 para. 1 no. 9, 12 and 13 AnlV in instruments of the same company and interests and securities of a closed-ended investment fund pursuant to sec. 2 para. 1 no. 17 AnlV shall not exceed 1% of the guarantee assets, in deviation from sec. 4 para. 1 AnlV.

In this context, the so-called holding privilege was applied, i.e. in case one or several holding companies whose only purpose is the holding of investments in other companies ("**Holding Companies**") are held between the investor and the target company, the 1% limitation has to be calculated with regard to the investments of the investor in the actual target company, rather than the Holding Company.

The holding privilege was confirmed by the Capital Investment Circular (clause B.3.5 e) of the Capital Investment Circular). With regard to investments in a participation via an investment fund, the investment fund was considered to qualify as a Holding Company and the 1% limitation was calculated based on the investments in the respective target company. However, this former interpretation now contradicts a BaFin statement due to which the 1% limitation has to be calculated at the fund level with regard to investments in closed-ended investment funds pursuant to sec. 2 para. 1 no. 13 b) and 17 AnlV (clause B.3.5 e) of the Capital Investment Circular.

An exemption is provided in case the investment fund invests in target funds. In this case, the 1% limitation has to be calculated based on the investment in the respective target fund. Therefore, BaFin still applies a look-through approach with regard to the 1% limitation in fund of fund structures. The narrowing of the holding privilege will prove to be a challenge, particularly to investors with a comparably small investment volume.

4. Summary

The Capital Investment Circular deviates only to a small extent from the provisions set out in the Draft for Consultation which entails a partially significant impact on investments of regulated investors in private-equity funds, special funds and other funds. Hence, our view is that the Capital Investment Circular partially contradicts current administrative practice and the will of the legislator.

The Capital Investment Circular results in a stricter administrative practice of the BaFin. Therefore, the Capital Investment Circular raises questions with regard to both grandfathering procedures for existing investments, which BaFin has not addressed in the circular, and for the management of future investments. Nevertheless, it does not appear impossible to reach an appropriate outcome and to enable reasonable investments in the future.

Please do contact us if you have any further questions with regard to the Capital Investment Circular. Our lawyers listed below will be happy to attend to any questions you may have.

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