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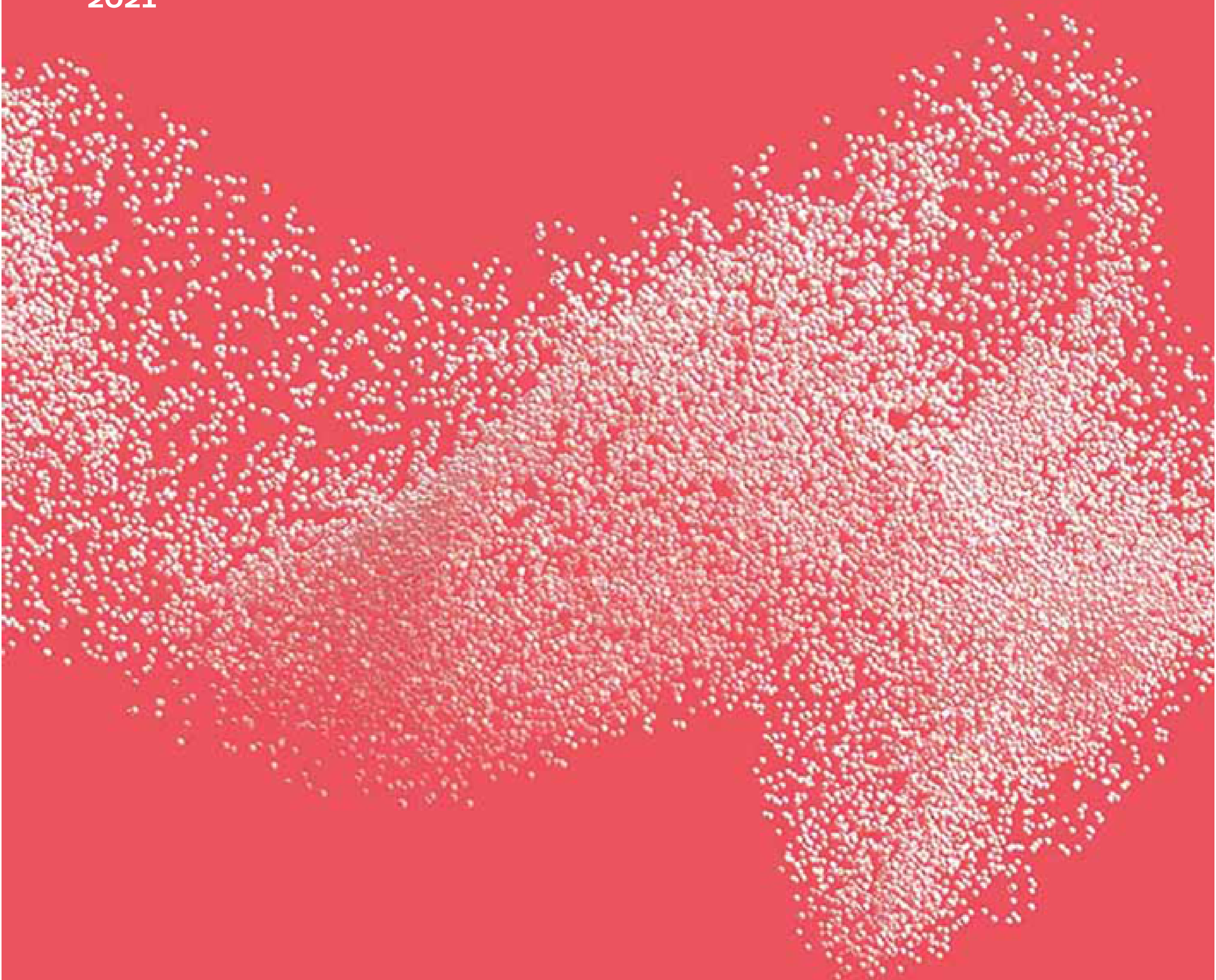
Eliminating barriers: Strengthening Germany as a Fund Jurisdiction

2021



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Overview

As at 20 January 2021, the German Ministry of Finance published a draft bill (last editing 12 January 2021) to strengthen Germany as a fund jurisdiction and the implementation of the directive (EU) 2019/1160 amending Directives 2009/65/EC and 2011/61/EU with regard to cross-border distribution of collective investment undertakings (“**Draft Bill**”). As such the Draft Bill, amongst others will amend the German investment code (“**KAGB-Draft**”), the German income tax act (“**EStG-Draft**”), the German value added tax act (“**UStG-Draft**”) and the German investment tax act (“**InvStG-Draft**”).

In addition to the implementation of the EU cross border distribution directive into German law, the legislator took aim to eliminate existing barriers in order to make Germany more competitive as a fund jurisdiction but without jeopardizing the high standards of investor protection.

Executive Summary

1. New vehicles in the German fund universe

Under the Draft Bill, additional fund structures will be made available to better cater for the requirements of the fund industry. Due to the fact that the proposed fund types are well established in other jurisdictions, the proposal does not purport to be an innovation but rather a means to level the playing field to allow management companies to use German domiciled vehicles instead of the respective counterpart in other jurisdictions.

a) Closed ended contractual special investment funds (Geschlossene Spezial-Sondervermögen - sec. 139 KAGB-Draft)

Sec. 139 of the KAGB-Draft introduces special investment funds in the form of closed ended contractual investment funds which presents an alternative to the investment limited partnership and investment stock corporation structures currently available under applicable law in Germany. Under the German Investment Tax Act ("**InvStG**") closed ended funds in the contractual form are treated as opaque with no option to elect transparent tax treatment. To opt for transparent taxation it would be required that the fund qualifies as a special investment fund within the meaning of sec. 26 InvStG. However, such qualification cannot be met by the new fund vehicle, given that as a closed ended vehicle it cannot facilitate mandatory annual redemption as required under sec. 26 no. 2 InvStG. As a consequence, the new vehicle will be merely an alternative to funds established as an investment stock corporation with some more flexibility as the setup of a contractual investment fund is not constrained by the additional layer of company law provisions. In addition, closed ended contractional funds should offer cost advantages as compared with investment stock corporations.

Compared to (tax transparent) investment limited partnerships, opaque closed ended contractual investment funds would have (as an investment stock corporation) the disadvantage of an additional level of taxation for certain types of income, but may have advantages as (i) the tests for avoiding trade tax at the fund level are less strict for opaque

funds compared to funds organized as

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partnerships and (ii) funds organized as partnerships bear the risk for certain tax exempt German investors (e.g. *Pensionskassen*) that their tax exempt status is jeopardized. This risk does not exist for investments in opaque funds.

It remains to be seen whether closed-ended contractual investment funds will gain in popularity with professional investors. This will depend on how the new vehicle will serve their specific regulatory and tax requirements:

- As an alternative to funds structured as investment stock corporation with fixed capital, the new closed ended contractional funds may also make attractive partial tax exemptions available if structured properly.
- Contractual investments funds may prove to be more cost efficient than corporate funds.
- Contractual investment funds are expected to outperform other structures in terms of time to market.

b) Open ended real estate funds in the form of an investment limited partnership (Offene Investmentkommanditgesell-schaft - sec. 91 (3) KAGB-Draft)

Currently open ended real estate funds may only be established in the contractional form (c.f. sec. 91 para. 3 KAGB). According to the Draft Bill in the future open ended real estate funds may also be established in the form of a partnership. However, only professional and semi-professional investors may acquire interests in open ended investment limited partnerships (c.f. Sec. 127 para. 1 KAGB). Therefore the new vehicle may only be used for special fund investment strategies. This adds a new tax transparent vehicle to the investment universe of special funds for real estate evergreen structures. As a consequence of the tax transparent structure, tax benefits under relevant double tax treaties are in general available based on the tax status of the investors in the fund. Therefore, the new vehicle may be attractive as a pension pooling vehicle. As compared to contractual investment vehicles the new vehicle allows for control elements available to the investors as commonly seen in limited partnerships.

However, it also increases administrative complexity.

The intention of the legislator to provide additional fund vehicles is a valuable step to strengthen the German asset management industry. However, it is disappointing that the legislator does not seem to be inclined to further liberalise the available vehicle universe for all asset classes such as open ended stock corporation as a vehicle for real estate (c.f. sec. 93 para. 3 KAGB-Draft).

c) Open ended contractual infrastructure funds (Offene Infrastruktur-Sondervermögen - sec. 260a et seq. KAGB-Draft)

The Draft Bill provides a dedicated fund vehicle that allows retail investors to participate in the returns of infrastructure investments. In order to underpin the character of a collective infrastructure investment at least 60% of the gross asset value ("GAV") of the assets of the new vehicle must consist of infrastructure project companies, real estate and usufruct rights. Furthermore the new vehicle has to comply with the following investment.

Eligible assets	Investment restrictions	Cash reserve
➢ Infrastructure project companies ➢ Real estate ➢ Securities ➢ Money market instruments ➢ Bank deposits ➢ Money market funds ➢ Derivatives for hedging purposes	➢ Exposure to infrastructure project companies must not exceed 80% of GAV ➢ Exposure to a single infrastructure project company must not exceed 10% of GAV ➢ Exposure to real estate must not exceed 30% of GAV ➢ Listed securities must not exceed 20% of GAV	At least 10% of GAV must consist of: ➢ Money market instruments ➢ Bank deposits ➢ Money market funds

Infrastructure project companies are defined as undertakings, which by virtue of its bylaws are set up in order to erect, refurbish or to operate facilities, installations, buildings or parts of it in each case in order to serve the public interest (c.f. sec. 1 para. 19 no. 23a KAGB-Draft).

The restriction of real estate investments to not more than 30% of GAV apparently should prevent the mislabelling real estate funds as infrastructure funds. However, it should be noted that real estate (buildings) is an eligible asset for infrastructure project companies. Consequently, with the view to real estate infrastructure there is an overlap in the asset classes. According to the explanatory memorandum of the Draft Bill infrastructure project companies shall not consist of real estate. Due to the fact that the wording of the definition clearly includes buildings and public facilities and therefore falls within the scope of infrastructure we assume that certain types of real estate (social infrastructure such as townhalls and schools) could be structured as infrastructure project companies based on the legal arrangement of the bylaws of the infrastructure project company.

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The long life of infrastructure investments calls for an adequate term of the fund or even an evergreen structure which in the past could not be catered for by the closed ended funds vehicle for tangible assets within the meaning of sec. 261 et seq. KAGB. (Note that the BaFin restricts the term of closed ended funds to a maximum of 30 years.)

However, the open ended nature of the new infrastructure fund vehicle has to bridge the illiquid nature of the underlying assets and the requirement of fund units to be redeemable at least on an annual basis (c.f. Sec. 260c KAGB-Draft). This illiquidity gap may be bridged by innovative downstream structures in the form of publicly traded companies which are already known in the renewable sector as YieldCo. To this end publicly traded companies could fit in between the investment restriction to invest in no more than 80% in infrastructure project companies and the minimum cash requirement of 10% of GAV.

2. More flexibility in downstream structuring

a) Shareholder loans in the context of real estate funds (Sec. 240 KAGB-Draft)

The Draft Bill brings some welcome clarifications around the use of shareholder loans in real estate funds for efficient structuring. According to the Draft Bill the restriction of shareholder loans (i) to 50 % of the value of the real estate held by the real estate company as borrower and (ii) of all shareholder loans to 25% of the value of the real estate held by the fund in aggregate will not apply if the real estate company directly or indirectly is owned entirely by the fund. However, it has to be ensured that the shareholder loan will be repaid prior to the disposal of the real estate company. Even if we may expect to see some further clarification in the code as it enters into force later this year it is expected that some of the restrictions will remain even if such restrictions seem not compelling for investor protection reason. For example a shareholder loan to a holding company which will be sub-lend to real estate company remains not permissible under the current Draft Bill.

b) Leverage of real estate special funds (sec. 284 para, 2 no. 3 KAGB-Draft)

The increase of permissible LTV for contractual real estate special funds with fixed investment conditions from 50% to 60% is – according to the explanatory memorandum of the Draft Bill – intended to provide capital management companies with more flexibility in times of crisis. By the same time it levels the playing field with Luxembourg fund vehicles structured for German investors subject to the restrictions of the German investment ordinance (Anlageverordnung – “AnlV”). The increase from 50% to 60% LTV under the Draft Bill allows to exploit the maximum leverage limit of 60% LTV permissible under the AnlV.

Fortunately during the course of the legislative process the legislator aligned the tax requirements with the regulatory requirement by increasing the LTV restriction for the qualification assessment of the special investment fund status within the meaning of sec. 26 InvStG to 60% LTV as well. As an effect a special real estate fund can still be structured as a tax transparent vehicle even if the LTV is increased to 60%.

3. Closed ended master feeder structures for retail AIFs (sec. 272a et. seq. KAGB-Draft)

In the past master feeder structures were only available to retail investors in the form of open ended structures. The Draft Bill now allows closed ended master feeder structures for retail AIFs (*Publikums*-AIF) in the newly implemented sec. 272a to 272h KAGB-Draft.

The opportunity to open closed ended master feeder structures to retail investors was created in order to provide more flexibility to investment management companies with regard to the structuring of their products and to broaden the scope of products available to

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retail investors in line with the overall goal to strengthen the position of Germany as investment fund jurisdiction.

Sec. 272a to 272h KAGB-Draft basically reiterate the requirements for open ended master feeder structures in sec. 171 et seq. KAGB allowing for deviations in case the nature of a closed ended vehicle so requires or a provision refers to UCITS requirements.

An important difference to open ended master feeder structures is that a closed-ended fund must not be restructured to a closed ended feeder fund.

Although the proposed increase in flexibility has in general been welcomed by the industry, it was criticized that closed ended feeder funds available to retail investors were prohibited from investing in open-ended master funds.

In our view making available closed ended master feeder structures to retail investors is probably of limited impact. The legislator has consistently refrained from providing an interface from retail products to institutional products and continues to do so with the suggested amendments.

Further, it must be noted that this amendment does not broaden the universe of eligible assets or loosen investment limitations of vehicles eligible for retail investors.

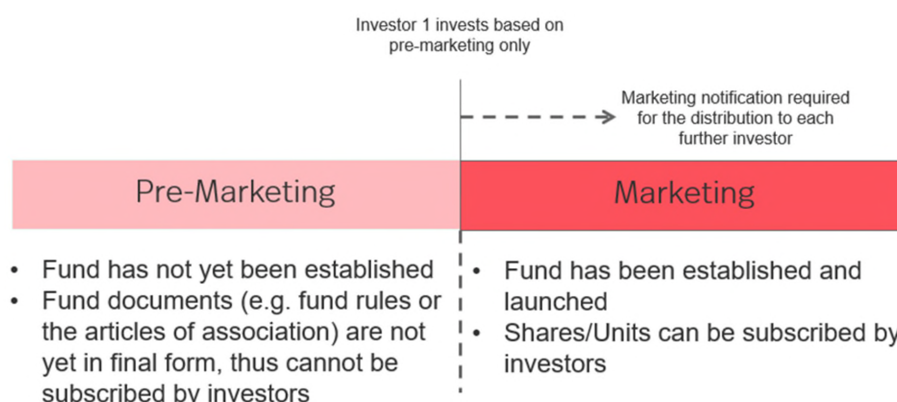
4. Pre-marketing/Distribution

a) New rules on pre-marketing and definition of pre-marketing

- Applicability of pre-marketing rules and changes to previous German regulatory law on pre-marketing and marketing

  Previously, there had not been any statutory law in Germany governing pre-marketing. The line between pre-marketing and distribution has previously been drawn both pursuant to sec. 293 KAGB, which legally defines marketing, and the BaFin guidance relating to marketing (as depicted in Figure 1 below). In this respect, in Germany, a marketing notification was only required if the line towards marketing had been crossed. The new rules on pre-marketing require AIFMs to additionally notify any pre-marketing conducted. As of 2 August 2021, "pre-marketing" will be legally defined in the KAGB for the first time and AIFMs will be required to file a pre-marketing notification before the fund is actually marketed. The marketing notification procedure, however, remains unchanged. Therefore, a marketing notification of a fund is required if the fund is already in existence. According to BaFin guidance, a fund (amongst other criteria) is in existence if it (i) has already been established, or (ii) the fund documents (e.g. fund rules or the articles of association) are in final form (i.e., draft terms and conditions of the fund which still can be negotiated and are therefore not ready for subscription are not sufficient). In this respect, it remains to be seen if BaFin guidance will be adapted as a result of the new pre-marketing rules.

Figure 1: Prior distinction between pre-marketing and marketing under German regulatory law



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- Definition of "pre-marketing" under the new pre-marketing rules

The pre-marketing rules follow a 1:1 implementation as provided for in the Directive (EU) 2019/1160 amending the AIFMD. According to the definition of pre-marketing as implemented into the KAGB, "premarketing" means "provision of information or communication, direct or indirect, on investment strategies or investment ideas by an AIFM or on its behalf, to potential professional or semi-professional investors domiciled or with a registered office within the scope of the KAGB or to professional investors domiciled or with a registered office in a Member State of the European Union or another Contracting State to the Agreement on the European Economic Area in order to test their interest in an AIF or a compartment which is not yet established, or which is established, but not yet notified for marketing in accordance with distribution rules, in that Member State where the potential investors are domiciled or have their registered office, and which in each case does not amount to an offer or placement to the potential investor to invest in the units or shares of that AIF or compartment."

The KAGB also specifies which information is prohibited when conducting pre-marketing. This comprises, for example, information that is sufficient to allow investors to commit to acquiring units or shares of a particular AIF. The same applies for subscription forms or similar documents whether in a draft or a final form. Similarly, constitutional documents, a prospectus, information in accordance with art. 23 AIFMD or offering documents of a not-yet-established AIF may not be in final form as part of pre-marketing. AIFMs must ensure during pre-marketing that investors are not provided with information that is sufficient to allow investors to take an investment decision.

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- Scope of applicability of the pre-marketing rules

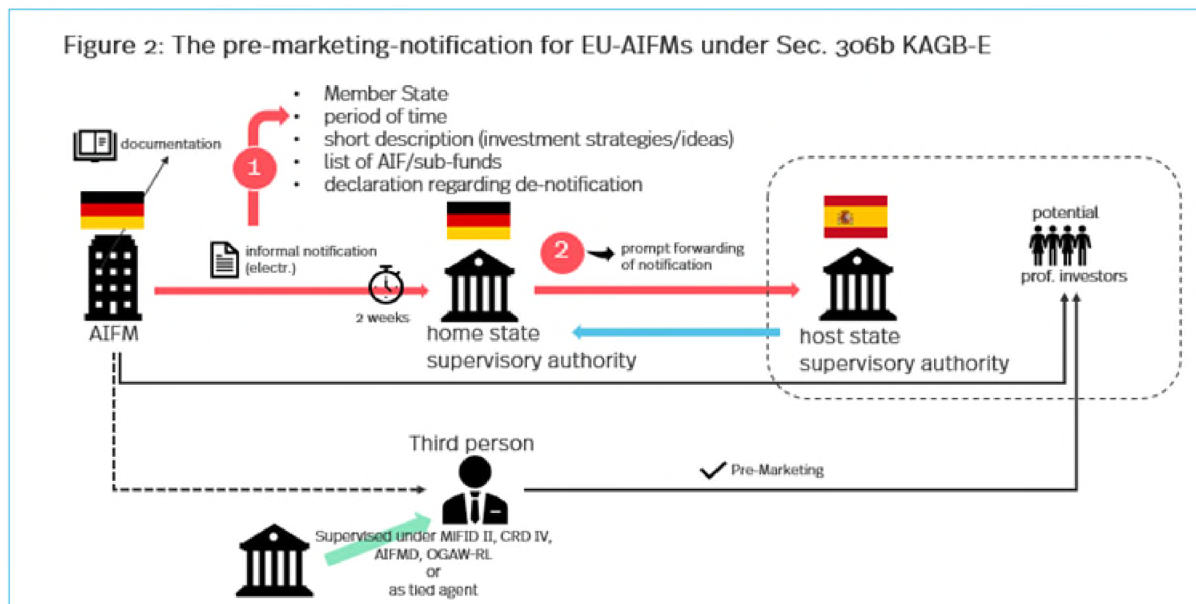
The rules on pre-marketing exclusively concern AIFs, not UCITS. Both non-EU-AIFMs and EU AIFMs are subject to the pre-marketing rules. While the pre-marketing definition of Directive (EU) 2019/1160 only takes into account "EU AIFMs", non-EU-AIFMs are also covered by the definition to be implemented in the KAGB. Recital 12 of Directive (EU) 2019/1160 requires that the harmonised rules on pre-marketing to be transposed into national law "should not in any way disadvantage EU AIFMs vis-à-vis non-EU AIFMs". This has been duly considered in the draft act.

Pre-marketing may only be conducted by the AIFM itself or such third parties that are either authorised under MiFID II, CRD IV, AIFMD or UCITS-Directive or that act as tied agent. Financial investment brokers (*Finanzanlagenvermittler*) which are registered under sec. 34f of the German Trade Code (*Gewerbeordnung*) are not listed as authorised third persons. From this follows that financial investment brokers are not authorised to conduct pre-marketing even though the core activity of financial investment brokers is to distribute funds that are registered with the BaFin for distribution.

- Requirements of EU-AIFMs to comply with pre-marketing

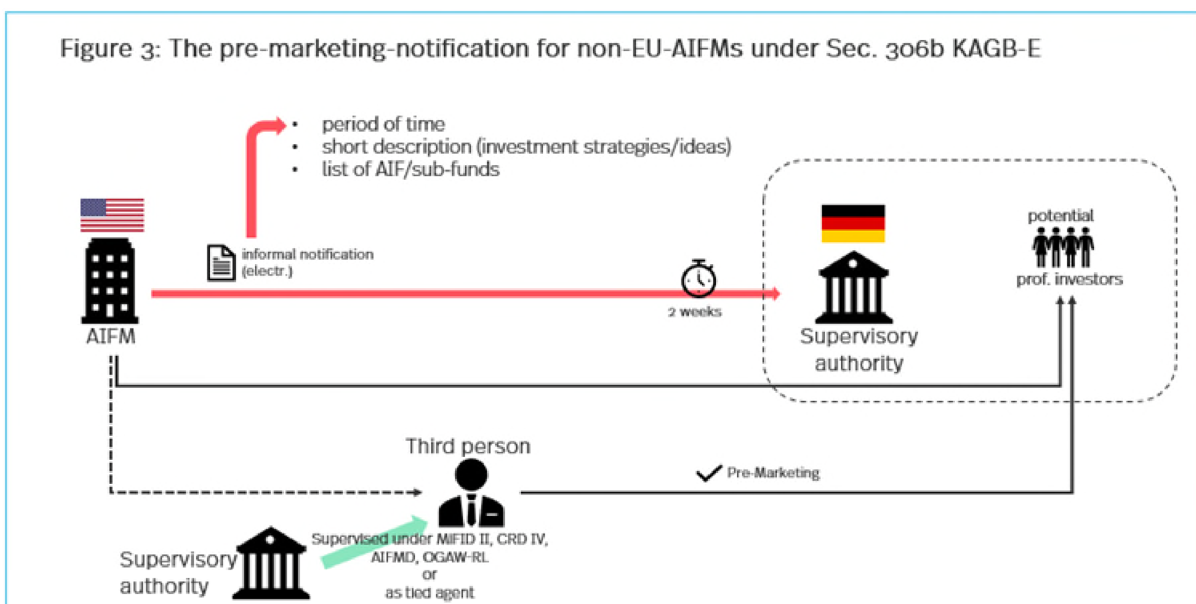
As of 2 August 2021, EU-AIFMs will be required to file a pre-marketing notification within two weeks of the EU-AIFM having begun pre-marketing to its respective home state supervisory authority ("Home NCA"). Such pre-marketing notification will inform the Home NCA of the commencement of pre-marketing activities and the information depicted in step 1 in Figure below. The Home NCA will immediately forward such pre-marketing notification to the supervisory authority of the Member State ("Host NCA") in which pre-marketing is taking place or has taken place vis-à-vis potential professional investors. If pre-marketing is taking place or has taken place in more than one Host NCA, the Home NCA will forward the pre-marketing notification to all relevant Host

NCAs. The Host NCA may request additional information on the pre-marketing conducted by the relevant EU-AIFM from the Home NCA. Violations with respect to the notification period are an administrative offence and may be prosecuted by the BaFin. Figure 2 depicts the pre-marketing requirements for EU-AIFMs.



- Requirements of non-EU-AIFMs to comply with pre-marketing

As of 2 August 2021, non-EU-AIFMs will be required to file a pre-marketing notification within two weeks of it having begun pre-marketing to such supervisory authority in the EU, in which pre-marketing is taking place or has taken place vis-à-vis potential professional investors. Violations with respect to the notification period of two weeks are an administrative offence and may be prosecuted by the BaFin. Figure 3 depicts the pre-marketing requirements for non-EU-AIFMs.



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- Implications on subscriptions to AIFs on a reverse-solicitation basis

  According to the legal reasoning of the Draft Bill relating to the pre-marketing definition, pre-marketing should not lead to the exclusion of reverse solicitation, i.e. the initiative to acquire shares in an investment fund by the potential investor. The legal reasoning continues by stating that the definition is intended to show that the mere advertising of the AIFM's own capabilities must be distinguished from the advertising of a specific investment fund.

- Implications on subscriptions to AIFs on a reverse-solicitation basis if pre-marketing has commenced

  If pre-marketing activities are taking place or have taken place, AIFMs must take into account a lock-up period of 18 months before investors can subscribe on a reverse-solicitation basis. This is because the KAGB will deem marketing to have occurred if an investor within 18 months of the start of pre-marketing subscribes to fund units that were subject of pre-marketing. In addition, the KAGB obliges AIFMs to ensure that investors do not acquire units or shares in an AIF through pre-marketing and that investors contacted as part of pre-marketing may only acquire units or shares in that AIF through marketing permitted in Germany. A violation to such obligation is an administrative offence and may result in prosecution by BaFin. Therefore, there are good arguments to conclude that even in the event that investors have not been individually contacted as part of pre-marketing of an AIF but pre-marketing of such AIF has taken place, investors may subscribe only if marketing of such AIF has been successfully notified in Germany. For more information on marketing notifications, please refer to our briefing "Distribution of Investment Funds".

- Electronic communication with respect to (pre-)marketing (de-)notifications

  As of 1 April 2023, AIFMs (i.e., German AIFMS, EU-AIFMs and non-EU-AIFMs) will be obliged to submit pre-marketing notifications, marketing notifications and marketing de-notifications electronically via an electronic communication procedure provided by the BaFin.

b) Marketing de-notification procedure

- Requirements for EU-AIFMs and EU-UCITS management companies in relation to marketing de-notifications

  In relation to EU-AIFs and EU-UCITS, there will be a harmonised de-notification procedure. With respect to a marketing de-notification, EU-AIFMs and EU-UCITS management companies must generally fulfil the following requirements:

  - a blanket offer is made to repurchase or redeem, free of any charges or deductions, all such units held by investors in that Member State, is publicly available for at least 30 working days and is addressed individually to all investors,
  - the intention to terminate arrangements made for marketing such units in that Member State is made public, and
  - any contractual arrangements with financial intermediaries or delegates are modified or terminated with effect from the date of de-notification.

The below Figure 4 depicts the requirements that must be met with regard to marketing denotifications and outlines the flow of transmitted information.

The legal reasoning underlines, that the liquidation of the investment fund due to a termination of the management right is not subject of the marketing de-notifications. UCITS management companies and EU-AIFMs shall continue to fulfil their information obligations towards those investors who remain invested after a marketing de-notification.

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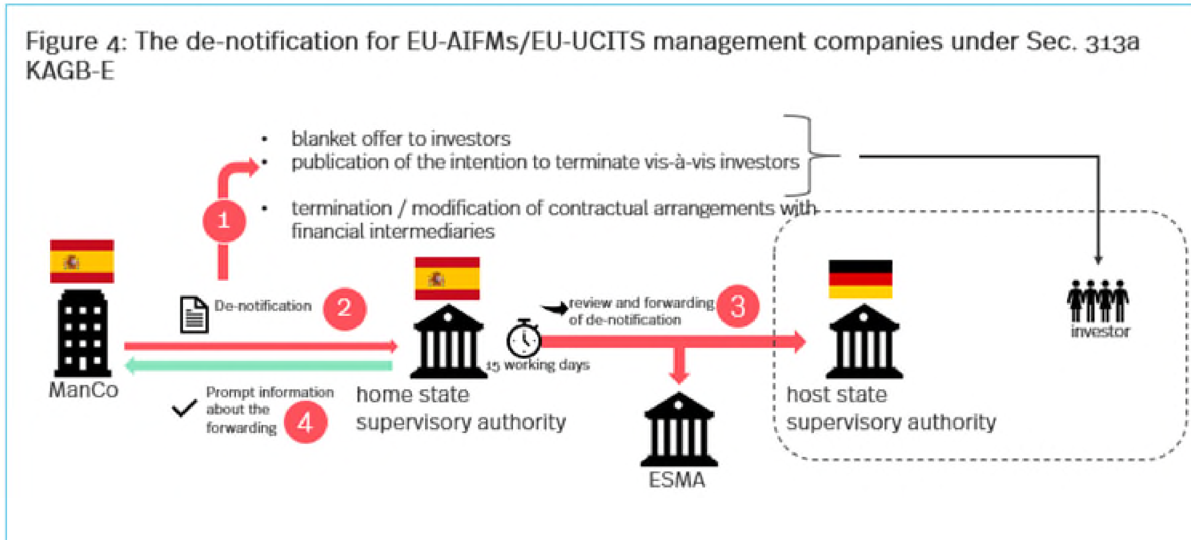

Figure 4: The de-notification for EU-AIFMs/EU-UCITS management companies under Sec. 313a KAGB-E

- **Requirements for non-EU-AIFMs in relation to marketing de-notifications**

  The requirements to de-notify a registered fund e.g. in Germany do not differ to the requirements. However, the non-EU-AIFM must de-notify bilaterally to the supervisory authorities in each Member States in which it has registered its fund for distribution. The non-EU-AIFMs can therefore not avail of the passporting easement to only de-notify vis-à-vis one single supervisory authority in the EU. Figure 5 below depicts the requirements that must be met for a non-EU-AIFM to de-notify a registered AIF in Germany.

  Even though the new rules harmonise de-notification procedures, they will cause an increase in administrative burden for non-EU-AIFMs. For example, all that was previously required to de-notify an AIF registered under sec. 330 KAGB, was to submit to BaFin a wet ink signature confirmation from the AIFM that marketing of the relevant AIF had been discontinued in Germany and that all investors resident or domiciled in Germany had terminated their investment in the relevant AIF.

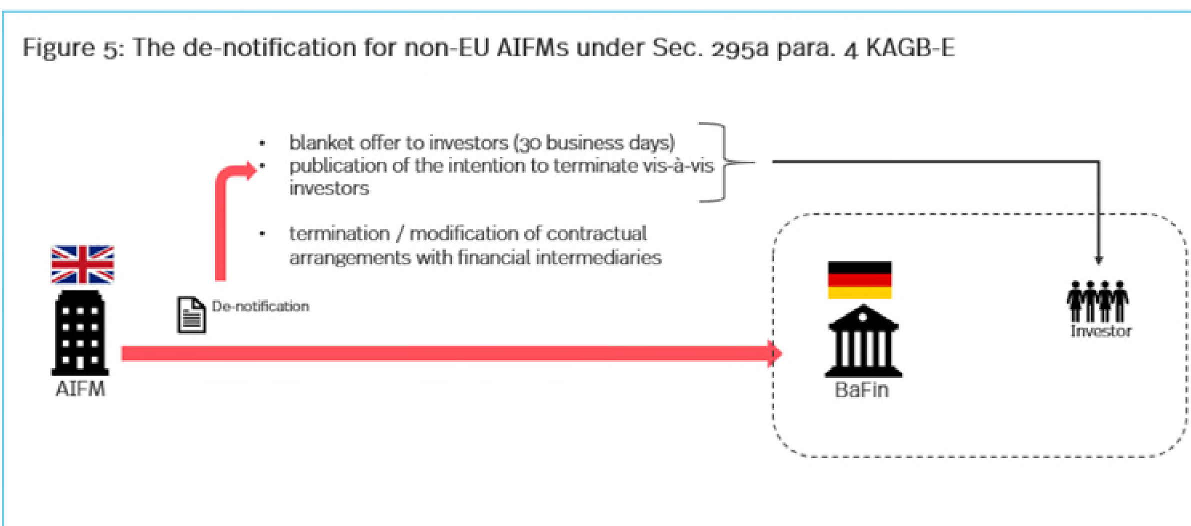

Figure 5: The de-notification for non-EU AIFMs under Sec. 295a para. 4 KAGB-E

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- **Pre-marketing lock-up period of 36 months after de-notification**

  Pre-marketing activities will be prohibited for a period of 36 months with respect to such AIF or such AIF's comparable investment strategies or investment ideas which have been de-notified from the time of submission of a de-notification. The 36 months lock-up period is a 1:1 implementation by the Directive (EU) 2019/1160. Respective funds may therefore only be pre-marketed after the 36 months lock-up period or may be subscribed to if the marketing of such AIF has been successfully notified.

5. ESG disclosure rules

- **Background to the ESG disclosure requirements**

  The consideration of environmental, social, and governance ("ESG") factors by asset managers is not a new phenomenon, but its significance for asset managers, in particular for those managers domiciled in the EU, is growing. With the recent legislative initiatives in the EU and the regulatory scrutiny, ESG has become an increasing priority for investors and a key consideration in asset allocation. The recent changes in investor behaviour are in line with the European goals of sustainability.

  Following the adoption of the Paris Agreement on climate change and the UN 2030 Agenda for Sustainable Development in 2015, the EU set in motion an ambitious legislative programme to support the transition to a low carbon, more resource-efficient and sustainable economy. The Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector ("SFDR") is the keystone of the European legislative architecture. This section provides an overview of the implementation of the most important new disclosure requirements under the SFDR into German financial regulatory law. The SFDR was published in the Official Journal on 9 December 2019, and was subsequently amended by Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 ("TR"), itself published in the Official Journal in June 2020. Most of the SFDR disclosure requirements will not become effective until 10 March 2021.

  Further information on the European ESG regulatory framework can be accessed through Simmons & Simmons' website.

- **Information to be disclosed in the pre-contractual disclosures**

  Under the SFDR, AFIMs and UCITS management companies shall disclose ESG-related information in the respective pre-contractual disclosures for AIFMs and UCITS. The scope of the product-related disclosure obligations depends on the specifics of the respective financial product(s). AFIMs and UCITS management companies must, therefore, determine whether a specific financial product is in or out of scope of enhanced disclosure requirements for ESG-focused financial products set forth in art. 8 et seq. SFDR. Where a financial product neither promotes ESG characteristics nor has sustainable investment as its objective, the disclosure requirements are consequently limited.

  Pursuant to art. 6(1)(a) SFDR, AFIMs and UCITS management companies must disclose in the pre-contractual disclosures the manner in which sustainability risks are integrated (or, if not deemed to be relevant, a clear and concise explanation of why not) into their investment decisions in relation to the specific financial product. In addition, in-scope firms shall, pursuant to art. 6(1)(b) SFDR, disclose the results of an assessment of the likely impacts of sustainability risks on the return of the particular financial product. In accordance with art. 8 *et seq.* SFDR, in-scope firms are required to disclose additional specified information in the pre-

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contractual disclosure for a financial product but also on its respective websites, and in the periodic reports provided to investors in respect of financial products which promote ESG characteristics and products with sustainable investment or a reduction in carbon emissions as their objective. The overarching aim of pre-contractual disclosures is to provide information reflecting the characteristics of the product that will not mislead investors (i.e., preventing "greenwashing"). Additionally, if the financial product promotes environmental characteristics, pre-contractual information must also provide, pursuant to art. 5 (in conjunction with art. 6 TR), the percentage of the investments underlying the financial product that qualify as environmentally sustainable economic activities. For products pursuant to art. 8 SFDR, the TR requires in-scope firms to also include a statement in the pre-contractual information stipulating that the "do no significant harm" principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities. Where a financial product is not subject to art. 8 or to art. 9 SFDR, the information to be disclosed in in the pre-contractual information shall, pursuant to art. 7 TR, be accompanied by the following statement: 'The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities.

The German legislator intends to introduce the aforementioned product-related SFDR disclosure requirements into German law by amending the respective pre-contractual disclosure requirements under the KAGB. With respect to the pre-contractual information requirements vis-à-vis retail investors, the sales prospectus of an open-ended retail investment fund (cf. sec. 165 para. 2 no. 42 KAGB-Draft) and the sales prospectus of a closed-ended retail AIF (cf. sec. 165 para. 2 no. 42 in conjunction with sec. 269 para. 1 KAGB-Draft) shall contain the information pursuant to art. 6 to 9 SFDR as well as art. 5 to 7 TR. Regarding pre-contractual information requirements vis-à-vis (semi-)professional investors, the pre-contractual information shall also cover such information (cf. sec. 307 para. 1 sent. 2 no. 20 KAGB-Draft).

- Information to be disclosed in the periodic reports

Art. 11 SFDR requires AIFMs and UCITS management companies of financial products within the meaning of art. 8 or 9 SFDR to include certain sustainability disclosures in the periodic reports for the particular product. The provisions concerning periodic disclosures apply from 1 January 2022.

Where AIFMs and UCITS management companies make available financial products within the meaning of art. 8 SFDR, they shall describe the extent to which environmental or social characteristics are met in the period reports. AIFMs and UCITS management companies making available financial products within the meaning of art. 9 SFDR shall describe the overall sustainability-related impact of the respective product by means of relevant sustainability indicators. Where an index has been designed as a reference benchmark, AIFMs and UCITS management companies shall include a comparison between the overall sustainability-related impact of the financial product with the impacts of the designated index and of a broad market index through sustainability indicators. The content, methodologies and presentation of information in relation to the disclosure requirements under art. 11 SFDR will be specified by delegated acts. In addition, the information set out in art. 5 or 6 of the TR shall be disclosed in the respective periodic disclosures.

The German legislator intends to introduce the aforementioned product-related SFDR disclosure requirements into German law by including a reference to the respective

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disclosure requirements under SFDR and TR in no. 7 of sec. 101 para. 1 sent. 3 KAGB-Draft.

- Compliance of in-scope firms with their disclosure obligations

  Compliance with the SFDR disclosure requirements shall be audited by auditing companies. The Draft Bill provides for an extension of the catalogue of requirements to be audited. In accordance with sec. 38 para. 3 sent. 2 no. 7 KAGB-Draft, the auditor of an external capital management company shall determine whether the respective in-scope firms complied with the disclosure requirements under art. 3 to 10 and 12 to 13 SFDR and art. 5 to 7 of TR. The auditor of both an investment stock corporation (Investmentaktiengesellschaft) and an open-ended investment limited partnership (offenen Investmentkommanditgesellschaft) shall, in accordance with sec. 121 para. 3 sent. 1 no. 2 lit. f and g; and sec. 136 para. 3 sent. 2 no. 6 and 7 KABG-Draft, determine whether the respective in-scope firms complied with the disclosure requirements under art. 3 to 13 SFDR and art. 5 to 7 of TR. In this respect, the audit scope will also cover the SFDR disclosure requirements pursuant to art. 11 SFDR in contrast to the audit scope pursuant to sec. 38 para. 3 sent. 2 no. 7 KAGB-Draft. The official justification given for the Draft Act, in particular the justification for the amendments to sec. 38 para. 3 sent. 2 no. 7 KAGB-Draft, does not provide for a reason in relation to the different audit scope. Rather, the German legislator seems to assume that the auditor will also assess compliance with SFDR information disclosure requirements regarding information to be disclosed in periodic reports. It is yet to be seen whether the German legislator will amend the reference to the SFDR during the course of the legislative procedure.

- Responsible authority and prosecution of administrative offences

  The BaFin shall, in accordance with sec. 5 para. 13 KAGB-Draft be the competent authority within the meaning of art. 14(1) SFDR to the extent that the rights and obligations under the SFDR apply to management companies and investment funds within the meaning of the KAGB. In this respect, the BaFin shall be authorised to take measures that are appropriate and necessary to monitor whether the SFDR and the delegated acts and technical implementing and regulatory standards adopted on their basis are complied with.

  With respect to both SFDR and TR disclosure requirements the German legislator will not change the administrative offences catalogue. Violations to disclose respective information will be covered by the existing catalogue.

6. Value Added Tax (sec. 4 no. 8 lit. h UStG-Draft)

Under existing German VAT law, only the management of UCITS or AIFs comparable to UCITS is VAT exempt, which is a great disadvantage for the German fund industry. The Draft Bill contains an expansion of this VAT exemption for the management of venture capital funds (Wagniskapitalfonds), but the scope of the expansion remains unfortunately largely unclear as the Draft Bill does not contain a definition of the term "venture capital fund". It is also unfortunate that the VAT exemption shall be expanded only for venture capital funds, but not for other AIFs. The new provision shall apply from 1 July 2021 onwards.

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7. Income tax deferral for employee participations

The Draft Bill provides in sec. 19a EStG-Draft a tax incentive for the participation of employees in the employer company (in particular in the form of shares, convertibles and profit participation rights, but not in the form of virtual participations). It says that wages in the form of such participations shall no longer be taxable already at the time of the transfer of the participation to the employee, but that income tax on such benefit in kind will become due only at a later point in time, usually upon sale, at the latest after ten years, or upon a change of the employer. Hence, the contemplated provision would avoid a taxation of "dry income", where no cash is paid to the employee.

The Draft Bill says that the acquisition costs of the granted participations (which are equal to the amount on which the employee has to pay income tax in case of a trigger event) need to be recognized at the market value (gemeiner Wert) of the participation at the time of the granting. However, as venture capital participations are often hard to value and as wages are taxed higher than capital gains it is anticipated that if the law is enacted as suggested there could be many disputes around the correct valuations. Another point of criticism is that only participations in the employer are benefitting from the deferral scheme, but not participations in other group companies, in particular in group holding companies.

The new provision shall apply from 1 July 2021 onwards and is limited to micro-enterprises as well as small and medium-sized enterprises (SMEs) that were incorporated not more than ten years ago. The following thresholds apply for qualifying SMEs: less than 250 employees, annual turnover not exceeding 50 million euros or annual balance sheet total not exceeding 43 million euros.

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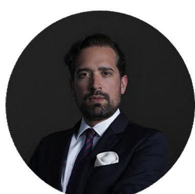

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