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The German Capital Investment Act's Impact on US Private Equity Funds Part 1 – Fundraising and Transactions in Germany

The German Capital Investment Act (the "KAGB") became effective in July 2013, thereby replacing the German Investment Act ("InvG"). Previously, an investment fund would either be regulated by the InvG or be part of the unregulated "grey market". The KAGB now broadly defines investment funds, leaving no room for unregulated entities (other than certain expressly stipulated exemptions). According to the KAGB, an "Investment Fund" (Investmentvermögen) is every collective investment undertaking, with a number of investors, that raises capital with a view toward investing in accordance with a defined investment strategy for the benefit of those investors and which is not a commercial operating company.

An Investment Fund either may be qualified as an undertaking for collateral investments in transferable securities (UCITS, or in German OGAW) or as an Alternative Investment Fund ("AIF"), which can be closed-end or open-end. Both closed-end and open-end AIFs can either qualify as specialized or retail Investment Funds. Specialized AIFs may, according to their constituting documents, only be marketed to professional investors or semi-professional investors, both as defined in the KAGB. All other AIFs are retail AIFs. In general, the intensity of regulation increases from closed-end AIFs to open-end AIFs, and from specialized AIFs to retail AIFs. Private equity funds typically qualify as closed-end specialized funds and enjoy a relatively low degree of regulation. US managed, US funds are not subject to regulation by the KAGB as long as they do not market shares or units in Germany.

Under the KAGB, "fundraising" is defined as any direct or indirect offering or placement of units or shares in an Investment Fund. According to the Federal Financial Supervisory Authority ("BaFin"), an "offering" is not merely limited to a formal, binding offer, but is broader, including, for example, an invitation to submit an offer (invitatio ad offerendum). On the other hand, a placement requires an active marketing of units or shares. Merely responding to an order by an investor is insufficient and investment conditions must be fully negotiated (Angebotsreife). According to BaFin, "marketing" will not be deemed to have occurred even if an Alternative Investment Fund Manager ("AIFM") approaches potential investors with investment proposals and then negotiates the investment conditions with the investors and finally sells shares or units in the AIF to exactly those investors. The reasoning behind this is that at the outset the investment conditions were not fully negotiated, and when the negotiations were finalized there was no additional marketing activity by the AIFM (provided that no further marketing is intended).

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Once fundraising activities qualify as marketing, they have to comply with a phased regime. Until presumably mid-2015, an AIFM seeking to market to professional and semi-professional investors must notify BaFin of its intention to market units or shares of an AIF in Germany and comply with extensive BaFin obligations prior to authorization, as well as appoint someone to carry out depository functions and comply with certain transactional restrictions. BaFin will then notify the AIFM whether fundraising activities may begin. The AIFM also will be subject to general ongoing reporting obligations. For US managed, US private equity funds, grandfathering provisions may apply (until July, 21 2014) where units or shares in AIFs were already marketed in Germany before July 21, 2013.

After presumably mid-2015, there will (only) be a European passport regime for specialized funds, allowing for Europe-wide marketing with authorization from only one member state. For private equity funds, this means that the passport regime is the only available regime if, according to the fund's constituting documents, marketing only may be directed towards professional investors. To utilize the passport regime, an eligible AIFM may seek authorization in a member state of reference (one where it intends to market units or shares of its managed AIFs) and file a notification and an application for authorization with BaFin.

As discussed above, private equity funds in Germany face new regulatory challenges. While the requirements are extensive, the European passport offers some advantage for funds looking to implement European fundraising strategies. So far it seems the advantages outweigh the disadvantages, but only time will show the overall effect of the KAGB.

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