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LAWYERS AND TAX ADVISORS

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The German Law Implementing the AIFM Directive: Its Effects on the Fund Industry in Germany

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The second draft on the implementation of the AIFM Directive of 30 October 2012 is now available. The high demands placed on AIF managers in the first draft regarding internal processes, risk management, external securities depositories, valuation, ongoing compliance with debt limits, and compulsory licensing are unchanged.

The AIFM Directive on Alternative Investment Fund Managers is to be implemented in Germany under the draft law of the German Finance Ministry through the introduction of the Kapitalanlagegesetzbuch [Capital Investment Code] (KAGB). This will create a uniform regulatory framework for all funds previously regulated under the Investmentgesetz [Investment Act] (InvG), including the OGAW/UCITS funds. The implementation of the AIFM Directive in German law must be completed no later than 22 July 2013.

The coming regulation will have significant consequences for the fund industry. The focus of the initial European regulatory effort was unquestionably the hedge funds. In practice, however, the scope of application of the AIFM Directive as it is to be implemented in German law includes both open and closed fund structures (private equity funds, hedge funds, and infrastructure and real estate funds), as well as renewable energy and shipping funds. Special funds are also affected. A positive list of permissible assets was expanded, but has apparently not yet been finalized.

The draft of the KAGB unquestionably aims at the one-to-one implementation of the AIFM Directive. In several respects, however, the draft of the Finance Ministry goes beyond the binding minimum requirements of the AIFM Directive and imposes a stricter regulatory framework on the German fund industry than intended by European lawmakers. In perhaps the most significant departure from the AIFM Directive, the draft of the KAGB also comprehensively regulates funds with low asset bases. The Finance Ministry justifies this proposal with an increased concern for the protection of investors.

The Draft of the KAGB Includes the Following Significant Areas of Regulation:

- The InvG previously made a distinction between investment companies and depositary banks, both of which must act as fiduciaries for their investors. This “investment triangle” will now also apply to unregulated fund structures. The concept of the depositary bank will be replaced by that of the external securities depository.

- The AIFM Directive requires that external securities depositories be provided for each AIF. The depository is responsible for the safekeeping of the AIF's assets, in particular financial instruments, for proper monitoring of the AIF's cash flows, and also for ensuring the effective acquisition of ownership of assets by the AIF. The draft of the KAGB includes the provision that only banks, securities firms, and certain other comparable supervised institutions may serve as external securities depositories. It does not contain the provision of the AIFM Directive under which other service providers such as, e.g., lawyers and auditors, may be appointed as external securities depositories.

- With the Investmentkommanditgesellschaft [Limited Investment Partnership] („InvKG"), a new statutory investment asset has been introduced. Accordingly, in future, a new closed fund vehicle will be available in Germany beyond the existing fixed-capital investment company.

- Under the draft of the KAGB, it will only be possible to set up new hedge funds as open special AIFs which may be held solely by professional investors. The placement of "special investment funds with increased risk" with private investors, previously permitted under the InvG, will thus be prohibited. To the extent that special investment funds with increased risk have previously only been permitted to invest in a specific list of permissible asset types, hedge funds will be able in principle to acquire all assets conceivable for AIF.

- Open funds within the meaning of the KAGB are only those funds whose investors may exercise their right to redeem their shares at least once per year. The purchase of new shares in a fund must be permitted four times per year. All other AIFs are thus classified as closed funds. As private equity funds typically invest in illiquid assets and provide investors with no or heavily restricted redemption rights, private equity funds will thus generally be considered closed funds. In future, then, private equity funds will only be permitted to be set up as closed fixed-capital investment stock corporations or as closed investment companies.

- The launching of new real estate funds will, after all, not be possible solely in the form of closed funds, either as public AIFs or special AIFs. After heavy criticism from the fund industry, the most recent draft put forward by the Finance Ministry deleted the previously announced prohibition on open-ended real estate funds. However, in future, property funds will as a general principle be classified as AIFs. Certain fund-related provisions of the KAGB will then also be applicable to open-ended real estate funds.

- Under the draft of the KAGB, investors shall be classified as "professional investors" or "private investors". Professional investors are deemed to have sufficient experience, knowledge, and the necessary professional judgment to evaluate the risks involved in their investment decisions. Private investors must be provided with the material investor information, the sales prospectus, and the most recently published annual financial statements and mid-year report in its current version at no charge and in due time before purchasing AIF shares. In addition, before concluding the investment contract, the potential investor must be provided with the most recent net value of the fund's assets or the most recent market price of its shares or equities. The investment terms and conditions must generally be included with the sales prospectus.

- The classification of investors into professionals and private investors is made according to objective criteria. "Born" professional investors can only be legal entities such as banks, funds, insurance companies, and other institutional investors. The law will provide the option for investors to have themselves classified in the other category. This will permit e.g. private investors to also act as professional investors.

- The sale of shares in any AIF may only commence after official notice has been given to the BaFin. The existing notification procedure will continue to apply to OGAW funds. The regulations governing the notification procedure for AIF are multilayered, and distinguish between the sale of domestic AIFs, European AIFs, and AIFs from third countries. It is also of importance whether the sale is to private or professional investors. The utilization of an EU passport in the case of sales to professional investors is intended.

The draft of the KAGB contains general transitional regulations for AIF management companies and AIFs. Under these provisions, an application for a license must be made to BaFin within a period of one year, from 22 July 2013 and ending on 22 July 2014. It should be noted that, as of the day the new law takes effect, new AIFs may only be established upon granting of a corresponding license by the BaFin.

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Amendment of MaRisk

4. Amendment to MaRisk Planned

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The Bundesanstalt für Finanzdienstleistungsaufsicht [Federal Agency for Financial Services Supervision] (BaFin) intends to present a reworked draft of the „Mindestanforderungen an das Risikomanagement“ [Minimum Requirements for Risk Management] (MaRisk). The primary reason for this fourth amendment to the MaRisk is the adaptation of Section 25a KWG [the German Banking Act], which necessitates the CRD IV reforms drawn up by the European Commission concerning changes to the own capital regulations.

Background

BaFin has announced its intention to publish a fourth amended version of the MaRisk. This has been made necessary by the increased demands on risk management under CRD – IV, as well as various standards of the European Banking Authority (EBA). The changes are largely concerned with capital planning processes, risk management and controlling processes, and the liquidity transfer pricing system. In addition, institutions will also be required to maintain their own compliance function. It remains to be seen, however, to what extent the suggested changes and amendments proposed by various institutions and trade associations as part of the consultative process will be taken into account in the final version.

Continued Validity of Existing Principles

BaFin explicitly notes that BaFin will retain its principle-oriented structure and the proportionality principle. To the extent compatible with the statutory objective of the appropriateness and effectiveness of risk management, smaller institutions in particular will benefit from exemption clauses, which permit some relaxation of the general risk management requirements. On the other hand, institutions of a size and importance giving them a certain relevance to the system will have to make provisions for risk management exceeding the minimum requirements of the MaRisk.

Material Changes

The risk-bearing capacity concept of financial institutions shall, in future, include a capital planning process with a stronger future orientation. The risk-bearing capacity calculations, usually made with a term of one year, should thus be supplemented with a planning instrument taking into account future capital requirements in the event of a change in the economic environment or the company's own business activities. This is intended to ensure that the company can identify its future capital needs at an early stage and implement appropriate measures.

In future, risk management and controlling processes will assume greater importance in determining risk-bearing capacity. A limit system must be implemented for all risks taken into account in the calculation, one which permits active steering measures to be taken and the assumption of excessive risk avoided. This process is already familiar from the requirements concerning the limitation of counterparty and market price risks.

The position of the director of risk controlling, who must in future be involved in all important decisions concerning risk policy, also increases in significance. This increased importance must also be reflected in his position within the company. Management of risk controlling must be exercised either by a managing director, or by an employee below the level of managing director; in larger institutions, this position must be filled by a managing director.

Perhaps one of the most significant BaFin requirements concerns the establishment of a compliance function. Such a function in accordance with Section 33 WpHG as read with the "MaComp" circular was previously only required of securities service providers in connection with compliance with the provisions of the WpHG; now, all institutions shall be required to ensure compliance with statutory provisions and regulations by means of a general compliance function. During the consultative process, parties potentially affected by this issued a sharp criticism that, in practice, it would be difficult to imagine how an internal firewall separating it from existing departments such as internal auditing and the legal department might be erected. In the course of their regular work, it was pointed out, these departments already deal with compliance-related matters.

It will thus be necessary to draw up a compliance framework which precisely delineates the scope of responsibility of the compliance function and ensures the availability of relevant information. Internal regulations must be established for all employees of an institution regarding compliance with the statutory provisions, and how such compliance shall be monitored. The compliance function must provide a report on its activities to management on at least an annual basis, as well as when the situation demands.

Outlook

Regardless of the specific wording of the final version of the new MaRisk, it is already clear that regulatory pressure will only increase, and that institutions will have to make significant efforts to comply with legislators' regulatory requirements. In addition to the amendments made to the MaRisk, new own-capital requirements are being introduced, the reporting system modified, and new demands made of employees in the financial advising sector.

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Organizational Obligations and Duties of Care in the E-Money Business

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Exceptions to Identification Requirements Facilitate the Issuance of E-Money in Germany

Integration into the ZAG was intended give a boost to the e-money sector in Germany. However, a major obstacle was presented by the requirement that the issuers of even low-value gift and customer cards were required to carry out the customer identification process mandated under money-laundering laws. The newly introduced Section 25i KWG takes aim at this problem, introducing for the first time a de minimis exemption below which the duties of care regarding money laundering do not apply to the issuing of e-money.

A. The E-Money Business in Germany

The e-money business is the issuing of electronically stored monetary values accepted by persons other than the issuer in the course of payment transactions. Among the forms of e-money are "network money" and "card money". The e-money business previously constituted banking within the meaning of the German Banking Act, with correspondingly high supervisory hurdles to overcome. With the intent of promoting the e-money business, it was transferred in 2011 to the regulatory jurisdiction of the Zahlungsdiensteaufsichtsgesetz [Payment Services Supervisory Act] (ZAG), and a new class of e-money institutions created. Even the reduction in starting capital this entailed, from EUR 1,000,000.00 to EUR 350,000.00, was not enough to make e-money (and particularly card money) a success. Instead, uncertainty among retailers grew: under the current administrative procedures of the Bundesanstalt für Finanzdienstleistungsaufsicht [Federal Agency for Financial Services Supervision] (BaFin), an electronic gift card issued by a retail chain may be classified as e-money even if it is only accepted in the chain's own stores (a closed-loop system), provided that the retail chain is organized in legally independent regional units. Consequently, each customer must be identified in accordance with anti-money laundering laws, necessitating the corresponding documentation. However, it is unrealistic to expect that a retailer selling a gift card in the amount of 20 Euros will go through the full process of identification in accordance with the Money Laundering Act.

B. The Exemptions of Section 25i KWG

This is where the de minimis exemption of Section 25i Para. 2 KWG comes into play, according to which identification for the purposes of the Money Laundering Act is not required if

- A maximum of 100 Euros may be stored on the e-money medium issued; in the case of reloadable media, reloading must be limited to 100 Euros per month;
- It is not technically possible to link the e-money issued with the e-money of another e-money holder or the e-money of another issuer, i.e. if the e-money cannot be transferred from one e-money medium to another; and
- The e-money may only be exchanged for cash up to an amount of 20 Euros.

In addition, Section 25i Para. 5 KWG made it possible for the BaFin to allow an issuer of e-money to comply with only a reduced duty of care under Section 5 of the Money Laundering Act, or to exempt it from compliance with other requirements, as long as the e-money medium presents only a minimal risk of money-laundering, the financing of terrorism, or other criminal acts in accordance with Section 25c Para. 1 KWG.

C. Consequences for Issuers of E-Money

The de minimis exemption of Section 25i Para. 2 KWG and a potential dispensation under Section 25i Para. 5 KWG do not change the fact that the issuer is engaged in the e-money business, and thus requires a corresponding license. With regard to, e.g., electronic gift cards and customer cards with payment functions, it is only the waiver of the money-laundering identification requirement under the de minimis exemption that makes the issuing of such cards practically feasible for retailers. Whether issued by the retailer itself or by a specialized payment service provider on its behalf, e-money can once again be issued with legal security and at an economically justifiable cost.

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The Euro Risk – New Demands on Contract Drafting

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The Euro crisis has recently been dominating the headlines. High-ranking politicians have already speculated that Greece will leave the common currency. Some politicians at the national level and certain economists have even demanded such a step. Even the dissolution of the Euro was predicted by some. What consequences would such a scenario have for companies active on an international scale? How might they hedge against these risks?

Exit from the Euro

In the event that one or more countries leave the Euro, the goal must be to ensure that Euro-denominated receivables stemming from contracts with companies in threatened countries (Greece, Spain, and Italy, but also Ireland and Portugal) are later paid in Euros, rather than in some new national currency. To this end, the parties must explicitly agree on the currency in which receivables are to be denominated. A simple choice of applicable law, such as German law, or the statement of an amount in Euros is not enough. If push comes to shove, the supposedly Euro-denominated amount owed by a debtor in one of the crisis-stricken states would simply be converted on the basis of a country's conversion law into the new national currency as of a particular date (recurrent link), with the national currency then subject to massive devaluation. Payment of the receivable in the new currency would mean a significant loss of purchasing power for the creditor.

Options for Contract Drafting

To avoid this result, contracts with debtors in crisis countries should in all cases include a specific provision regarding the currency in which the debt is denominated. Options range from a simple renegotiation clause in the event of a currency changeover, an explicit statement that the debt shall remain denominated in Euros even after a currency conversion or that it shall be payable in a particular foreign currency (e.g. CHF, USD, GBP), or an indexing clause taking into account the expected decline in purchasing power of the debt or a compensation clause fairly apportioning such a risk. The corresponding provision should be buttressed with effective (i.e. exercisable at an early stage) rights of rescission or termination (in particular MAC (material adverse change) clauses) and other provisions (e.g. force majeure clauses).

Avoid the Nexus

Independent of this, any unnecessary nexus between a contract and a crisis state should be avoided. Under no circumstances should the jurisdiction of the courts of the crisis state be accepted. When possible, contracts should be concluded with independent subsidiary companies in "safe" Euro countries. Other transactions between the parties, such as contract negotiations, signatures, and contract performance, should also not be carried out in a crisis state.

A Collapse of the Euro

At present, a complete collapse of the Euro appears unlikely. However, the consequences of such a collapse are incalculable. Whether, when, and how national currencies would be reintroduced is completely unforeseeable today. This risk can largely be eliminated only through an agreement to denominate debt in a foreign currency. Even then, and regardless of exchange rate risk, an implementation risk remains, as a country's currency conversion law would have to permit agreements on foreign currency-denominated debts.

Existing Contracts

To the extent that contracts have already been concluded with debtors in a crisis state affected by a currency conversion, the possibility of an adjustment of the terms of the contract or the existence of a right of rescission based on the principle of frustration of the contract should be investigated. At least partially determinative in such case would be the question of whether the contract was concluded before Fall 2011, when the current extent of the Euro crisis was not yet foreseeable. For contracts concluded after that point, the preconditions for asserting a claim for adjustment of the contract are unlikely to be met.

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Conclusion: When entering into a new, long-term contract with a receivables debtor in a crisis state, it would be negligent not to include an express provision on the currency in which the debt is to be paid and the consequences of any conversion to a new national currency. The doctrine of frustration of the contract is no longer of any assistance.

A Pizza Service Requires a Banking License?!

Financial regulatory requirements for Internet platform operators with payment systems and implications for structuring e-commerce models under civil law

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At least since eBay had to delay the launch its new payment processing method, which was planned for this summer, because the German Federal Financial Supervisory Authority (BaFin) required a banking license, Internet platform operators have been wondering whether and to what extent their business models fall within the area requiring a license.

Whether a license is required depends on how the e-commerce model is structured in each individual case. The following article focuses on two topics that should be of significance to most platform operators: the regulations on e-money and the provision of payment services under the German Payment Services Supervision Act (ZAG).

E-Money

The duty to obtain a license may, first of all, arise under Section 8a(1) sentence 1 of the German Payment Services Supervision Act, under which anyone who wishes to engage in e-money transactions requires the written approval of the BaFin. According to the legal definition, "e-money" is any monetary value stored electronically, including magnetically, in the form of a receivable from the issuer, which is issued in exchange for the payment of a monetary sum in order to perform payment transactions as defined in Section 675f(3) sentence 1 of the German Civil Code, and which is also accepted by natural or legal persons other than the issuer.

The central feature of the definition of e-money is that e-money is accepted as a general means of payment by third parties, so that the electronic units can be used as a sort of "electronic wallet". E-money is consequently only considered to exist when the legal means of payment is converted into a type of electronic "parallel currency", which is accepted by third parties as legal tender.

This very broad interpretation of the term "e-money" is limited by two exceptions in Section 1a(5) of the German Payment Services Supervision Act. Under this provision, monetary assets that relate to payment instruments that can only be used as a means of payment on the business premises of the issuer (e.g., in a department store), or that can only be used for a limited selection of goods or services based on contractual agreements with the issuer (for example, credit in the area of public transportation or fuel cards) or that can only be used within a limited network of dealers or service providers (such as a soccer stadium or university campus) are not considered e-money. Monetary assets that only serve the purpose of paying for services that are exclusively processed via a telecommunications, digital, or IT device are also not considered e-money. The regulation primarily covers mobile telecommunications providers that issue prepaid telephone cards, which not only provide clients with talk time but also with offers for goods or services from third parties, such as ring tones, background images, or music, as well as conversational therapy services via telephone or SMS text.

We can currently only speculate on the conditions under which these exceptions may apply to operators of Internet platforms, because the BaFin emphasizes that it is ultimately a question that must be decided on a case-by-case basis. Therefore, e-commerce models should, as far as possible, be structured in such a way that units in virtual accounts do not fall under the definition of e-money. Thus, payment processes should ideally be limited to the relationship between the user and the platform operator. The challenge in drafting contracts in such a case is to structure contractual relationships and payment processes in such a way that the e-commerce model in question does not fall within the domain where licenses are required, and, at the same time, to avoid liability risks for the platform operators based on intermediary agent status.

Providing Payment Services

However, issuing e-money is – by far – not the only action that risks triggering an obligation to obtain a license. Platform operators in particular run the risk of providing "payment services" within the meaning of Section 1(2) of the German Payment Services Supervision Act and therefore being subject to the duty to obtain a license under Section 8(1) of the Payment Services Supervision Act.

The importance of coordinating with BaFin prior to adopting a business model is demonstrated by the September 29, 2011 judgment of the Cologne Regional Court – "Pizza.de/Lieferheld.de."

An intermediary agent for online food orders had been warned by a competitor that it required a BaFin license for its business model under Section 8(1) of the German Payment Services Supervision Act. The Cologne Regional Court decided in favor of the competitor. By receiving payments for the orders, e.g. via

PayPal, and subsequently passing them on to the suppliers, the defendant in the injunction proceedings performed a payment service in the form of a financial transfer transaction under Section 1(2)(6) of the German Payment Services Supervision Act. The fact that the payment service was only performed as part of another main activity (the arranging of food orders) was not considered contrary to the qualification of the defendant in the injunction proceedings as a payment institution for which a license should have been obtained. Since no "privilege for secondary services" can be derived from the European Payment Services Directive, providing a certain payment capability for the purpose of another primary transaction was considered sufficient to establish the required commercial nature of the payment service in order to qualify the company as a payment services provider under Section 1(1) No. 5 of the German Payment Services Supervision Act.

What makes the decision of Cologne Regional Court particularly controversial for platform operators is the fact that, in the view of the Regional Court, the obligation to obtain a license constitutes a market conduct regulation within the meaning of Section 4 No.11 of the German Act Against Unfair Competition and, as a result of the lack of BaFin regulations, the competition courts are not prevented from making their own decisions on the obligation to obtain a license. Therefore, a business model that might require a license can literally have its foundation destroyed overnight by a preliminary injunction obtained by a competitor.

Whether contractually structuring an e-commerce model in such a way that the platform operator does not process the payment, but rather accepts the payment for itself would be sufficient to preclude the obligation to obtain a license, is, however, doubtful: Under the payment processing method planned by eBay, which was blocked by the BaFin, the purchaser no longer transfers the purchase price directly to the seller, but rather transfers it to an eBay account. If there are no complaints on the part of the purchaser, the seller will be paid by eBay. In order to avoid liability, eBay does not act as an intermediary agent. Instead, it acquires its own claim to payment, which it allows to be assigned by the seller in advance, subject to a condition subsequent if the purchaser fails to pay the purchase price to eBay within 30 days. If this condition occurs, the receivable will be returned to the seller, who can then assert the claim against the purchaser himself or rescind the purchase agreement. The amount paid out to the seller is therefore not the purchase price to be paid by the purchaser, which eBay receives itself, but rather the gross value of the receivable that eBay bought from the seller. The BaFin obviously was not impressed by the contract structure, but instead gave preference to an economic approach.

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Conclusion: The hope that the BaFin will not learn of one's business model on its own often turn outs to be illusory. In light of the Cologne Regional Court's „Pizza.de/Lieferheld.de" decision finding unfair competition law relevant with respect to the obligation to obtain a license, additional financial supervisory risks now threaten from a corner where they would not initially be expected. Internet platform operators with payment systems are therefore advised to contact the BaFin at an early stage and seek a binding decision on whether they are required to obtain a license.

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