German Fund Location Act — Part II

EUROPEAN PRE-MARKETING RESTRICTIONS IMPLEMENTED BY THE NEW GERMAN FUND REGULATION

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The law to strengthen Germany as a fund location will essentially come into force on 2 August 2021 (the Fund Location Act – *Fondsstandortgesetz*), and the asset management industry will then face a significant legislative package amending the existing German Capital Investment Code (KAGB – *Kapitalanlagegesetzbuch*).

The Fund Location Act transposes the European Directive/2019/1160 on cross-border distribution of collective investment undertakings (CBDF Directive) into national law. To avoid competitive disadvantages for Germany, the domestic legislator has decided in favour of a one-to-one implementation, i.e. almost entirely without gold-plating the European rules. As yet, the Federal Financial Supervisory Authority (BaFin) has not commented on this, and new legislative materials provide clarity on only a few points, e.g. that pure capability management and reverse solicitation are in principle not excluded by the new restrictions.

This client briefing provides an overview of the new *pre-marketing rules* in Germany.

In a separate **Part I client briefing**, we give an overview of further legal changes introduced by the Fund Location Act; for example the expansion of the product range to include new impact funds, investments in crypto-assets and improved financing options for real estate funds.

1. Removal of the paying and information agent

As of August 2, 2021, fund managers will no longer require a paying and information agent when marketing UCITS or retail AIFs. This leads to considerable administrative and cost relief for fund managers.

In the future, UCITS ManCos and AIFMs must merely provide an (internal or external) facility that processes subscription, redemption and conversion applications, and serves as an information and contact point for retail investors. Under the German Fund Location Act, fund managers must be capable of performing these tasks in the German language and also by electronic means. It is clear that the physical presence or designation of a third party is not necessary.

Another relief concerns domestic and EU AIFMs: as of 2 August 2021, only non-EEA AIFMs will have to designate a representative to take over the compliance function in Germany.

2. Discontinuation of marketing (de-notification)

If marketing measures taken by the fund manager have not been successful, or all investors in a member state have redeemed their fund units, a de-notification of a fund can be useful. This is in order to avoid further costs and ongoing information obligations associated with the marketing of a fund. In accordance with the European *regulator-to-regulator procedure*, fund managers distributing a (domestic or EU) AIF or UCITS can discontinue marketing by sending a de-notification notice meeting certain formal criteria to its home state regulator [*reference to Ashurst Newsletter 17 Jul 2019*]. The de-notification will then be forwarded to the host state regulator, i.e. the member state in which the marketing takes place. If a non-EEA AIFM markets a fund in Germany under the NPPR regime (e.g. under Art. 42 AIFMD, sec. 330 KAGB), the de-notification notice must be sent to BaFin as the host state regulator.

Whether the new de-notification option will be used by AIFMs in practice remains to be seen, because for a period of 36 months it is not permitted to even perform (new) pre-marketing for AIFs affected by the marketing de-notification or for comparable investment strategies or investment concepts (Blocking period for AIFs). The broader the interpretation of the term "comparable", the less willing fund managers will be to de-notify a fund: for example, it is not uncommon for private equity or debt funds to launch a successor fund that invests in a new portfolio on the basis of a similar investment strategy. If the fund manager would be prevented from carrying out pre-marketing for this successor fund after de-notifying the predecessor fund, the fund manager may decide to maintain the marketing notification, even if no marketing activity is actually performed. While

the German regulator (BaFin) has not yet given any guidance in this regard, it would be appropriate to interpret "comparability" of investment strategies or investment concepts as narrowly as possible.

3. New pre-marketing requirements

Before taking into account the cost, time and the financial and reputational risks of marketing a fund, it is essential to give AIFM the opportunity to first test the market by providing potential investors with information on an investment idea. Such pre-marketing activities are even considered part of a fund manager's duty of care.

As the pre-marketing phase was not regulated by European law, and probably does not need this at all [*reference to Ashurst newsletter 12 Mar 2018*], the CBDF Directive seeks to establish a new EU-harmonised pre-marketing regime under the AIFMD. The EuVECA and EuSEF Regulations are similarly amended, while no such rules are yet stipulated for UCITS.

i. Pre-marketing definition

The German definition of pre-marketing generally corresponds with the European definition covering the following activities:

- an AIFM providing information or communications on investment strategies or investment ideas (directly or indirectly) to potential professional investors *as well as to semi-professional investors*, which is a category specific to Germany and includes for example smaller pension funds and foundations;
- activity designed to test the interests of the investor in an AIF not yet established, or, where established, not yet notified for marketing to the relevant regulator in accordance with AIFMD; and
- activity that does not amount to an offer or placement to the potential investor to invest in the AIF.

ii. Notification process (German AIFM)

A domestic AIFM must submit a notification to BaFin, as the home state regulator, within two weeks of commencing pre-marketing activities. BaFin then informs the relevant national competent authority (NCA) of the host member state where the AIFM has engaged in pre-marketing. The notification letter must include:

- the relevant member states and periods of pre-marketing;
- a brief description of the activities with information on the investment strategies presented;
- a list of AIFs subject to pre-marketing, if any;
- the German legislator exceptionally goes beyond the EU notification rules (gold-plating) in requiring a declaration that no de-notification of marketing has taken place in the last 36 months in the member states in which the AIFM engaged in pre-marketing (see blocking period above).

iii. Non-EEA AIFMs & Small AIFMs

Finding some support in the recitals of the CBDF Directive, the German pre-marketing rules also apply to *non-EEA AIFM* performing pre-marketing activities for funds in Germany. They are subject to the notification requirement, but without the specifications relevant to EU AIFMs only. In the notification process, non-EEA AIFMs are required to provide a brief description of the pre-marketing activities as well as the relevant periods and, where relevant, a list of AIFs subject to pre-marketing. This puts non-EEA AIFMs at a particular disadvantage because they cannot benefit from the EU passport regime. From this perspective, a glimmer of hope is that the CBDF Directive reserves the extension of the pre-marketing passport to non-EEA AIFMs for later review.

Small AIFMs registered to manage special (institutional, non-retail) AIFs should be considered out of scope of the German pre-marketing rules. This would be in line with BaFin's practice, according to which small AIFMs are not subject to the marketing rules and are permitted to market their institutional funds to professional and semi-professional investors without submitting a marketing notification.

iv. Third parties

The CBDF Directive requires that a third party which engages in pre-marketing activities on behalf of the AIFM must be a licensed entity in the EU. The Fund Location Act merely implements the EU catalogue of relevant licensed entities including tied agents, AIFM, UCITS-ManCo, investment firms and credit institutions. However, since mere pre-marketing in the form of testing investor appetite is typically not even a MiFID-relevant activity, this requirement stemming from the CBDF Directive was widely criticised by lawyers and academics.

In practice, there is debate as to whether the third party is required to send a *notification* to the regulator when engaging in pre-marketing on behalf of an AIFM. Conceptual wise, the better arguments speak for that AIFMs, including the non-EEA AIFMs, are primarily subject to the notification requirement. This should be coordinated between AIFMs and third parties at times.

In Germany, so-called *financial investment brokers* are very common and are subject to a local "MiFID-light" regime (sec. 34f. *Gewerbeordnung*). Even though such financial investment brokers are permitted to market funds (that are notified with BaFin), they are not mentioned in the new list of third parties and therefore not permitted to render pre-marketing activities. The exclusion of these locally licensed supervised companies may be criticised with good reason; although the legislator has ultimately chosen this route.

v. Pre-marketing restrictions

The CBDF Directive and the Fund Location Act restrict pre-marketing activities in several ways [*reference to Ashurst newsletter 17 July 2019*]: one requirement is that investors are not permitted to acquire fund units through pre-marketing. This can be achieved without much difficulty, since a subscription requires the consent of the AIFM to be effective.

In particular and in accordance with the CBDF Directive, AIFMs may engage in pre-marketing *except* where the information presented to potential professional and semi-professional investors:

- is sufficient to allow investors to commit to acquiring a particular AIF;
- amounts to subscription forms or similar documents whether in draft or final form; or
- amounts to constitutional documents, a prospectus or offering documents of a not yet established AIF in final form.

Where a draft prospectus or offering documents are provided, they shall not contain information sufficient to allow investors to take an investment decision and shall clearly state in a disclaimer that:

- they do not constitute an offer or an invitation to subscribe for units of an AIF; and
- the information presented therein should not be relied upon because it is incomplete and may be subject to change.

These rather vague requirements have been criticised for their potential adverse effects on existing well-functioning pre-marketing practice in Germany. From the investor's point of view, it hardly seems sensible to express an interest in a fund concept on the basis of incomplete and inadequate information; this applies all the more if the information relevant to the investor is already available, e.g. in an existing PPM for another country. However, the German legislator must implement these restrictions and has decided to take a word-by-word approach, which leaves major interpretation issues unsolved.

In addition to the above requirements, the European and domestic pre-marketing rules stipulate a so-called *marketing fiction*: if an investor acquires fund units within 18 months of commencement of pre-marketing, the subscription is considered to be a result of marketing and consequently the AIFM must then successfully complete a marketing notification procedure.

Concerns are being expressed in the market that in particular the marketing fiction would stress BaFin's long-standing and pragmatic practice, according to which institutional investors already involved in negotiations on a special fund structure, as is often the case, do not trigger a marketing notification requirement. From our point of view, BaFin should be able to maintain its existing argumentation, because in such co-negotiation situations there remains an absence of marketing on the part of AIFMs towards those investors. Hence, a marketing notification would only be required if there is a specific intention to market the fund to investors that were not involved in the fund structuring process. As regards pre-marketing, BaFin could likewise come to the conclusion that pre-marketing in terms of testing investor appetite does not apply to situations where an institutional investor is already involved in negotiations on the fund terms, and therefore design the special fund structure itself. However, this view would have to be confirmed by BaFin.

vi. Outside the scope of pre-marketing

In the explanatory text, the German Fund Location Act provides for two concepts that remain outside the scope of pre-marketing:

- **Reverse solicitation**

First, the new pre-marketing rules shall have no effect on reverse solicitation: "From the definition it follows that pre-marketing originates from or on behalf of the management company. If the initiative to acquire fund units comes from the potential investor (so-called reverse solicitation), this is neither marketing nor pre-marketing." This is a welcome clarification. Even though the concept of reverse solicitation can be derived from the EU passive freedom to provide services, and also finds some ground in the investment regulation, it is a grey area in practice and requires a case-by-case assessment.

The above-mentioned marketing fiction must also be seen in the context of reverse solicitation: There are good arguments that reverse solicitation is excluded for a period of 18 months with regard to those investors that were actually contacted in the course of pre-marketing. Other investors should, therefore, be permitted to subscribe for fund units on their unsolicited initiative. This view finds support in the passive freedom to provide services and also in recital 10 of the CBDF Directive, which states: "EU AIFMs should ensure that […] *investors contacted as part of pre-marketing* can only acquire units or shares in that AIF through marketing permitted under Directive 2011/61/EU". It would be helpful if BaFin confirmed this view in its existing Q&A on marketing of funds.

- **Capability Marketing**

In explanatory text, the German legislator also stated that the pre-marketing definition "also shows that the mere advertising of one's own capabilities by an AIFM is to be considered separately from marketing for a specific fund and does not lead to the exclusion of reverse solicitation". This is in line with BaFin's practice that pure capability marketing of an AIFM, for example mere information on the activity and reputation of the fund manager, does not constitute marketing as long as it does not relate to a specific product or fund.

In practice, the distinction between pre-marketing (e.g. information on investment ideas) and capability marketing (e.g. information on the general activity and reputation of the fund manager) will be difficult to draw since both activities typically do not relate to a specific fund. In addition, AIFMs must be aware that BaFin assumes a licence requirement under the German Banking Act (KWG) "if the German market is targeted in order to offer banking products or financial services repeatedly and on a commercial basis".

A combination of pure capability marketing and reverse solicitation remains to be a possible route, although this is a grey area, which paradoxically could become more so under the new pre-marketing rules.

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