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PRIVATE EQUITY AND
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ALTERNATIVE TYPES
OF FINANCING –
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12 Years
FYB FINANCIAL
YEARBOOK



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Alternative Depository for Private Equity Funds

With the introduction of the German Capital Investment Code („KAGB“) in the context of the implementation of the Alternative Investment Fund Manager Directive (“AIFMD“), the legislator has set up another regulatory institution also for private equity funds, namely the (alternative) depository as defined by Sections 8o et seq. KAGB to protect investors.

The depository plays a particular role as it is directly involved already in the ongoing business operations of the respective alternative investment fund (“AIF“) and the AIF capital management company (in Germany: “Kapitalverwaltungsgesellschaft“ or “KVG“) respectively as supervisory vehicle while the Federal Financial Services Supervisory Authority (“BaFin“) as well as any auditor, if engaged, may perform their controlling functions only at a significantly later point in time.

The implementation of the depository also for alternative asset classes originates from the adoption of the AIFM Directive in 2011, which had not only provided for other extensive regulatory and administrative requirements but which had also set forth the depository’s principle tasks. The following so-called Level 2 Regulation had then specified the depository’s duties and the contractual relationship between the KVG and the depository in detail. The depository then became binding by operation of law upon the introduction of the KAGB in 2013, which created the legal framework together with the Level 2 Regulation as regards the depository’s tasks and duties.

The “alternative depository“

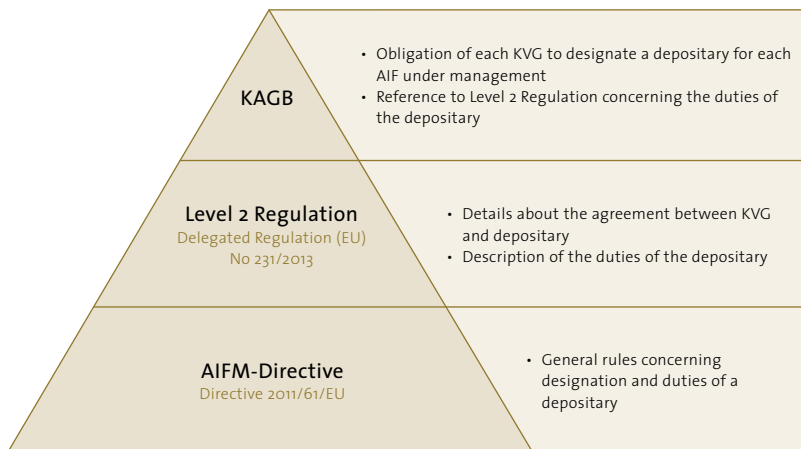
With regard to alternative asset classes, such as private equity funds („PE funds“), that do not acquire and hold the typical assets which can be held in custody,



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the legislator has created a so-called "alternative depository" in the form of a trustee as defined by Section 80(3) KAGB. These "alternative depositories" may be a constructive and reasonable alternative to the conventional depository bank solution for the responsible persons of the KVGs.



The trustee, who is typically an auditor, tax advisor or lawyer, performs the depository's tasks within the scope of his or her professional or business activities. By circular dated 18 July 2013, the BaFin commented more precisely on this issue in its "Guidance notice on the requirements for trustees acting as depositories in accordance with Section 80(3) KAGB". The BaFin's long-awaited "Depository Circular", which, however, so far only exists as a second draft, goes also into the particularities of the trustee as depository, whereat it refers to the aforementioned BaFin Notice regarding the trustee as depository when it comes to the specific provisions and requirements.

According to the BaFin's opinion, trustees have to prove that they have the required experience to assume the function of a depository, that, for example,

they have worked as consultant of a closed-end fund or in the administration of closed-end funds for several years. Trustees are, moreover, supposed to have "relevant legal and economic expertise with regard to the assets to be acquired for the funds as well as the legal and actual situation within the countries where they would be located". The requirement of the trustee's expertise is supported by the fact that the BaFin separately verifies the management's qualification in each individual case for each AIF to be supervised. In this regard particularly the specific demands as to the expertise on the concerned investment assets and the respective processes required for the respective asset class are assessed.

The responsible persons acting at the depository should thus mandatorily have the relevant expertise in the private equity sector considering the time-consuming and factually intense cooperation with the KVG.

Depository's tasks

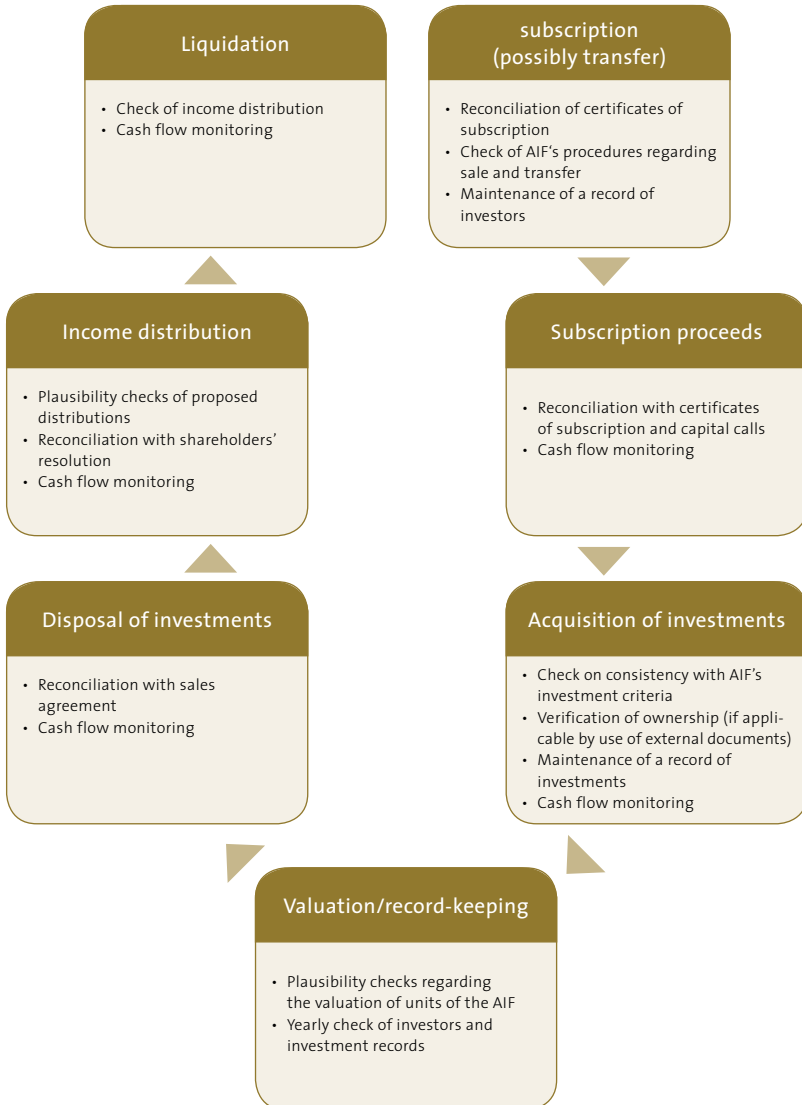
The depository/trustee ("depository" or "trustee") significantly interferes with individual activities of a PE fund manager (alternative investment fund manager or "AIFM") with the tasks to be performed by it/him or her. The depository is involved during the entire term of the AIF, from the investors' entry until the AIF's liquidation.

For the depository's main tasks within the following areas and/or stages of a PE fund, please see the process chart on page 62.

The particular aspects of the (alternative) depository for PE funds are covered by the following core topics:

■ Investors' entry

The trustee has to supervise the investors' entry into the AIF pursuant to the KAGB. This task includes the check of the certificates of subscription, the letters of acceptance, the capital calls as well as the tracking of the capital contributions. To the extent the depository supervises an AIF in the form of a so-called special



AIF, the depository's tasks also include the check of the investor forms and the relevant evaluation and categorisation of the (semi) professional investors to be made by the KVG.

■ „Deposit of assets which cannot be held in custody“

(Company) investments usually acquired by PE funds are classified as being so-called "assets which cannot be held in custody" according to the KAGB. The conventional deposit of financial instruments known from the structures under investment law in connection with depository banks does thus not apply to PE funds. Therefore, the depository's central task with regard to assets which cannot be held in custody is to check that the PE fund's investment policy is complied with, to subsequently verify the acquisition of ownership as well as to monitor the current cash flows.

Deposit of funds

The AIF's current accounts are generally managed by the AIF itself or by its AIFM. The trustee, however, is entitled to inspect the accounts to perform his or her duties of control. A blocking note may furthermore be entered in the AIF's current accounts (by defining basic threshold values, if applicable) so that significant transactions may only be carried out by the AIFM with the trustee's participation. Publicly offered AIFs even need the depository's approval by operation of law for certain transactions. The free disposability of the AIF's liquid funds by the KVG is thus materially restricted.

Verification of ownership

Another central duty of control to be performed by a PE fund's depository is not only to monitor the current cash flow but also to verify the effective transfer of ownership of the assets acquired by the fund; in the case of PE funds this means direct and/or indirect investments in companies. Hence, the depository has to verify the AIF's ownership of the so-called other assets – as opposed to financial instruments which must be deposited according to the KAGB – and provide a corresponding documentation. According to the KAGB, the depository may generally rely upon information, deeds, expert opinions and other documents provided by the KVG. Should these documents not be sufficient to deliver an adequate as-

assessment of the transfer of ownership, external documents have to be obtained if necessary by involving a third party in certain circumstances.

With regard to the PE sector, extensive questions of interpretation arise which have not sufficiently and finally be clarified so far. The assessment of an effective acquisition of an investment in a foreign target fund of a fund-of-funds, for example, cannot be compared with the direct acquisition of an investment in target companies by a direct fund.

Fund of fund

One should usually be able to adequately prove and document the effective entry into a domestic or foreign target fund on the basis of the signed subscription documents and existing records of investors. A confirmation of the effective indirect acquisition of an investment in a target company of the target fund is, in contrast, not part of the trustee's tasks, particularly as this would arguably not be realizable in practice also because of the usually too low investment amount and thus the little influence of the AIF, and as the target fund itself may be subject to a duty of depositary.

This, however, does not apply if the PE fund exercises substantial influence on the (direct) target company/target fund. In this case the depositary has to extend its scope of functions also to the structure controlled by the AIF by applying the so-called look – through approach if the controlled structure does not have its own depositary. It is therefore not possible to limit the scope of the depositary's activities by involving a so-called „blocker company“.

Direct-Fund

The verification of ownership is, however, much more sophisticated if a direct fund is to be supervised. Due to the direct holding structures, the acquisitions of the target companies are to be assessed in this regard. As already described, the depositary has to provide for sufficient certainty that the ownership of the target company has been acquired by the AIF on the basis of the documentation (information, deeds, expert opinions and other documents) available to the AIF. If the provided documents are not satisfactory, the trustee has to obtain further documents from the KVG. The trustee may also use the works of third party ex-

perts and engage third party experts respectively after prior agreement with and for the account of the KVG and/or the AIF.

This requirement is thus essentially based upon the requirements for auditors pursuant to the auditing standard „PS 302: Confirmation by third parties“, within the scope of which the trustee may rely, for example, upon certificates or expert opinions from third parties involved in the transaction (unless he or she has justified doubts as to the reliability of the involved parties) or subsequently engaged lawyers and auditors. The trustee may elect this option generally in case of transactions subject to foreign law.

This is where the specific requirements on a depository for PE funds become apparent. In the end, the depository implements continuous control procedures within the scope of ongoing business operations that should ensure the verification of the acquisition of ownership and the recoverability and thus the securing of assets. These tasks are basically similar to an auditor’s audit procedures regarding an investment, but this control occurs almost simultaneously with the respective transaction or least, very quickly.

In order to be able to make such an assessment – particularly as regards the KVG – within a reasonable time frame, the persons in charge at the depository must have many years of relevant experience in the structures to be supervised and the individual procedures and processes within a PE fund. Otherwise there is the risk that the AIF’s ongoing business operations are slowed down or that – in the worst case – individual investments are put at risk.

It is thus very important to define the procedures, responsibilities and duties not only of the depository but also of the KVG within the scope of such a new business relationship.

Contract of deposit

The KVG is obliged to enter into a written contract of deposit with the depository. This contract has to document the organisational procedures as well as the rights

and duties and contain other explicit provisions with regard to the effective exchange of information which enable the trustee to perform his or her duties as depositary, particularly his or her control functions.

■ Significance of the service level agreement

The individual provisions are to be documented in a so-called service level agreement („SLA“) to be attached to the contract of deposit as annex, and they are to be defined in consideration of the particularities of each asset class. The association of banks, for example, has already prepared model contracts of deposit for AIFs. The relevant procedures and processes must, however, actually be defined individually within the scope of the respective SLA specific to the asset class.

In this regard the definition of the time frame and the intensity of the depositary's controls are particularly problematic. The KVG, for example, has only a few days to adequately substantiate the investment opportunity and to subscribe the shares or units and pay the purchase price/commitment amount. It has usually conducted a due diligence review for some time, although the depositary cannot be involved in each internal review process. For this reason exactly defined factual processes and time frames are necessary and required in the relationship between the KVG and the depositary not to put the closing of the transaction at risk.

Hence, the central question is which information and documents have to be provided to the depositary in which form and at what stage of the process?

The SLA is thus essential as the future effects of the depositary's involvement in the AIF's ongoing business operations are defined and negotiated within its scope.

■ Ex ante or ex post?

In this context it is materially relevant to the KVG with regard to any and all procedures at what time the depositary takes which controlling measures: ex ante or ex post.

The KAGB does not contain any specific requirements, whereas in some areas an ex-ante control would certainly be recommendable depending on the process to be able to perform the controlling functions required by the legislator for investors' protection. According to the aforementioned draft "Depository Circular", the BaFin itself is of the opinion that the respective control dates must be considered in a differentiated way depending on the process.

Investors' entry

Regarding the supervision of the investors' entry as described above by checking the certificates of subscription, letters of acceptance, capital calls and payments, as well as the investor forms, if applicable, it is not necessary to involve the depository before the investors have been admitted. The depository's task in this respect is to assess the completeness of the documents and the evaluation and categorization of the (semi) professional investors to be made by the KVG, if applicable. The admission of the investors has, however, not to be approved.

Investment criteria

The review of whether the intended investment complies with the AIF's respective investment criteria should be made in due time prior to the transaction to avoid any subsequent issues of interpretation. For this purpose the KVG should involve the depository as soon as the investment substantiates and provide it with any material documents required to deliver the relevant assessment.

The SLA shall in this regard mandatorily define the relevant – from the KVG's point of view – adequate periods to provide the documents and obtain feedback and approval respectively from the depository to avoid any delays in the transaction or its failure. In case of different views, defined escalation proceedings apply other-wise that may end in a report to the BaFin.

Release for payment vs. cash flow monitoring

The current accounts are managed by the KVG as already explained. The depository, however, is entitled to reserve the release for payment or to have even entered a blocking note for certain transactions and to agree upon certain threshold values in each case.

The law does not provide for a full release for payment in the form of an ex-ante review of each transaction which would not be constructive either. The depositary by no means performs the tasks of a typical controller of funds who has to release each individual payment.

The intention behind the cash flow monitoring is to promptly check the liquidity flows as to their conformity with the underlying contracts and the plausibility of such payments. Insofar the prior review of the upcoming payments including their release by the depositary is recommendable only with regard to a few central issues.

Particularly the capital calls from the target funds and the purchase prices and/or rounds of financing regarding the target companies must be satisfied within the prescribed periods. Any delay in the payments by permanent review and approval processes to be carried out by the depositary may result in serious consequences for the relevant investment. In case of doubt the KVG may find itself forced to violate the provisions of the contract of deposit and to make payment without release (unless a blocking note has been entered). The depositary would in such a case, however, be obliged to take the appropriate measures up to a report to the BaFin depending on the definition of the escalation processes. In this respect it is imperative that feasible deadlines are set for the application for and release of payments.

As a result, the ex-ante release can, if at all, be recommended in connection with the subscription of a new investment in the context of the check of the investment criteria and the respective first capital contribution. The subsequent ongoing capital calls of the target funds may, however, be constantly reviewed promptly ex post. A release is not necessary in such a case. Similarly, it should be possible to review any further current account activities (such as receipt and payment of distributions, payment of other invoices of the AIF) subsequently.

Acquisition of ownership

With regard to the verification of ownership, the legislator stipulates that the depositary has to verify whether the AIF acquired the ownership of the assets to be acquired. The intention of the provision and the typical course of an underlying

transaction make clear that such review can only be made ex post. It is basically not constructive and cannot be the depository's duty to assess whether the draft contracts are fit to actually acquire the ownership of the asset to be acquired.

■ Completeness or random samples?

The depository is generally not obliged to fully control any and all business transactions of the AIF. Such full control is only provided for in certain cases such as – including but not limited to – a check of the investors, a check of the consistency with the investment criteria and the verification of the ownership of the acquired assets. With regard to the mainly ongoing activities of the KVG, a review of random samples of the respective transactions is sufficient. Consequently the SLA should also define the intensity of the individual reviews and controls, in particular such areas that require a full control, also to avoid later discussions, if any, regarding the scope of the documents between the KVG and the depository required for control.

Conclusion: constructive cooperation by professional experience

In summary it can be said that the depository is involved in material areas of the KVG's daily business operations. To avoid any misunderstandings in the interpretation of the rights and duties both of the KVG and the depository, the individual processes must be adequately specified and finally defined in the SLA attached to the relevant contract of deposit.

For this purpose and above all for the smooth implementation during the term of the AIF, the specific expertise of the persons in charge at the depository in the relevant asset classes as well as their structures and processes is indispensable and mandatorily required. Only if such experience exists at the level of the depository, will the depository not only be a „necessary evil“ but may actually back up the processes at the KVG substantially also with regard to the internal risk control.