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Fund Marketing in Germany: How new legislation impacts pre-marketing and reverse solicitation

On 20 January 2021, the German government published the draft bill *(Regierungsentwurf)* of an *Act to strengthen Germany as an investment fund location – Fondsstandortgesetz (FoG)* (the ***Draft Bill***). Among a number of changes to the German Capital Investment Code (the ***KAGB***) (Germany's legislative act which transposes both the Directive 2009/65/EC (***UCITS Directive***) and Directive 2011/61/EU (***AIFMD*** into national law), which are aimed at improving the conditions for the establishment of investment funds in Germany – e.g. by expanding the spectrum of available fund vehicles and granting certain tax reliefs –, the Draft Bill also implements Directive (EU) 2019/1160 of the European Parliament and of the Council of 20 June 2019 amending the UCITS Directive and AIFMD with regard to cross-border distribution of collective investment undertakings (OJ L 188, p. 106) (***Directive (EU) 2019/1160***). Directive (EU) 2019/1160 requires Member States to allow pre-marketing for AIFs but subjects it to a licensing requirement and a notification procedure. It further introduces a mechanism to prevent the units or shares of an AIF that has been subject to pre-marketing from being subscribed without complying with the relevant marketing rules as implemented pursuant to the AIFMD.

According to the Draft Bill, the German legislator intends to transpose Directive (EU) 2019/1160 without deviations in order to avoid competitive disadvantages for German fund managers and additional costs for investors. As expected, the implementation of Directive (EU) 2019/1160 will have significant consequences for the marketing of AIFs which are only available for professional and semi-professional investors in Germany (referred to as *Spezial-AIF* in Germany and further referenced as ***special AIF*** herein). This applies to EU AIF management companies (***AIFM***) as well as to non-EU management companies to whose marketing activities, according to the Draft Bill, the new rules will apply as well.

This briefing provides an overview of the main changes the Draft Bill brings in relation to pre-marketing and reverse solicitation.

Pre-marketing

Definition and scope

Pursuant to draft section 306b(1) sentence 1 KAGB, which shall transpose Article 30a(1) subparagraph 1 AIFMD, AIFMs may engage in "pre-marketing", subject to certain restrictions. The Draft Bill defines pre-marketing as an AIFM (or another person on behalf of the AIFM) providing directly or indirectly potential professional and semi-professional investors resident in an EEA member state with information or communication on investment strategies or investment ideas 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, 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 (cf. draft section 306b(1) sentence 1 KAGB).

By contrast, pure capability marketing without product relatedness by an AIFM should not qualify as pre-marketing (or marketing). According to the explanatory memorandum of the Draft Bill, it follows from the definition of pre-marketing *"[…] that the mere advertising of its own capabilities by AIFMs is to be considered separately from the advertising of a specific investment fund […]"*. This reasoning reflects the previous administrative practice of Germany's Federal Financial Supervisory Authority (***BaFin***), according to which the advertising of the own competence of AIFMs was not considered as marketing due to the lack of reference to a specific special AIF. The explanatory statement should be interpreted such that the promotion of the AIFM's capabilities does not constitute pre-marketing. Admittedly, since both pre-marketing and capability marketing may lack a product-relatedness, the distinction

between those two may be more intricate than the distinction between capability marketing and marketing.

The permission for AIFMs to engage in pre-marketing towards professional and semi-professional investors is not in itself a novelty in Germany, since – unlike in other EU Member States – certain forms of pre-marketing in the field of special AIFs have already been permissible pursuant to BaFin's administrative practice.

In accordance with Directive (EU) 2019/1160, pre-marketing is only introduced for AIFMs and not for UCITS management companies.

The inclusion of semi-professional investors goes beyond the text of the Directive (EU) 2019/1160 but follows the general concept of the German legislator to partially expand products available for professional investors to a certain group of investors which would, based on the definition in Article 4(1) point (aj) AIFMD, qualify as retail investors.

The inclusion of non-EEA AIFMs in the scope of the new legislation on pre-marketing is in line with the recitals of Directive (EU) 2019/1160 which requires Member States not to disadvantage EU AIFMs vis-à-vis non-EU AIFMs by the national regulations and administrative provisions transposing the harmonised rules on pre-marketing.

Limitation of information to be provided in the course of pre-marketing

With regard to the limitations and restrictions on the information that may be provided in the context of pre-marketing, the Draft Bill transposes the Directive's requirements of Article 30a(1) subparagraph (1) and (2) AIFMD almost word-for-word. Accordingly, the information presented to potential professional investors in the course of pre-marketing must not:

a) be sufficient to allow investors to commit to acquiring units or shares of a particular AIF;

b) amount to subscription forms or similar documents whether in a draft or a final form; or

c) amount to constitutional documents, a prospectus or offering documents of a not-yet-established AIF in final form

(cf. draft section 306b(1) subparagraph 1 KAGB).

Further, where a draft prospectus or offering documents are provided, they shall not contain information sufficient to allow investors to take an investment decision and they shall clearly state that: (i) they do not constitute an offer or an invitation to subscribe to units or shares of an AIF; and (ii) the information presented therein should not be relied upon because it is incomplete and may be subject to change (cf. draft section 306b(1) subparagraph 2 KAGB)

According to BaFin's FAQ on the distribution and acquisition of investment funds under the KAGB (*Häufige Fragen zum Vertrieb und Erwerb von Investmentvermögen nach dem KAGB*, last modified at 16 March 2018), AIFMs are allowed to share sample investment terms and prospectuses in the course of pre-marketing with professional and semi-professional investors, as long as they are in draft form and show gaps still to be negotiated. While it should remain permissible under the new rules to provide draft prospectuses as part of pre-marketing if their level of detail does not put the relevant investors in a position to finally commit to subscribe for units or shares in that AIF, the Draft Bill clarifies that the provision of draft subscription forms is inadmissible.

Application of the marketing rules

The mechanism prescribed by Directive (EU) 2019/1156, which shall ensure that the marketing provisions will be generally applicable subsequent to pre-marketing activities (cf. Article 30a(2) subparagraph 1 and 2 AIFMD), will be transposed without change according to the Draft Bill:

- Investors may not acquire units or shares in an AIF through pre-marketing (draft section 306b(2) sentence 1 KAGB, first alternative);
- Investors contacted as part of pre-marketing may only acquire units or shares in that AIF through marketing permitted by the KAGB (draft section 306b(2) sentence 1 KAGB, second alternative);
- Within 18 months from the commencement of pre-marketing, any subscription of an AIF which (a) was mentioned in information provided through pre-marketing or (b) which was established and registered as a result of pre-marketing, is deemed to constitute the result of marketing and is therefore subject to the notification procedure for the marketing of AIF (draft section 306b(2) sentence 2 KAGB).

The exact scope of these provisions remains uncertain. For instance, it is not clear whether the legislator actually intended that the contact to *any* investor in the course of pre-marketing renders the marketing rules applicable, irrespective of whether the contact with the relevant investor actually amounted to pre-marketing in the first place. This could be relevant where an AIFM successfully contacted the investor in the course of pre-marketing but did not provide the investor with information or communication on investment strategies or ideas because the investor was not interested. Second, it is questionable whether the marketing presumption shall also apply in respect of investors subscribing for units or shares in the AIF which were not even contacted in the course of the pre-marketing of that AIF and otherwise learned about the AIF during the pre-marketing (which has consequences for the application of reverse solicitation, for further details see below).

As regards Germany, these new rules would substantially change the regulatory treatment of pre-marketing practices by EU AIFM as well as third country AIFM in the field of special AIFs. According to BaFin's current administrative practice, pre-marketing is permissible and, under certain circumstances, the subsequent acquisition of units or shares of AIF which were subject to pre-marketing is possible without applying the marketing provisions. That is because, according to BaFin, an activity only constitutes marketing where it relates to an investment fund, which requires that such investment fund is either established or ready to be offered. If an AIF has not yet been established and the AIFM provides sample investment terms or draft prospectuses to professional or semi-professional investors, which are clearly not yet sufficiently developed to enable investors to subscribe for units or shares, and which are then negotiated by the parties, this has not been considered as marketing. BaFin regards the subsequent acquisition of units in the special AIF by those investors taking part in the negotiations not to constitute marketing within the meaning of the marketing provisions. By contrast, the offer or placement of units in this special AIF to other investors who had not participated in the negotiations prior to the establishment of the fund would be considered marketing.

It appears possible that, under the proposed rules on pre-marketing, this practice may become obsolete, as the provision of a draft prospectus and template investment terms constitutes pre-marketing and subsequently the presumption of marketing applies for a period of 18 months.

Licensing Requirement

Pursuant to a new section 306b(6) KAGB, which transposes Article 30a(3) AIFMD, third parties may only carry out pre-marketing on behalf of an AIFM if they belong to the following categories:

- tied agents pursuant to section 2(10) sent. 1 of the German Banking Act (KWG),
- investment firms pursuant to section 2(10) of the Securities Trading Act (WpHG),
- CRR credit institutions,
- UCITS management companies and
- AIFM.

In addition, "pre-marketing" shall be included in sections 20(2) no. 4 KAGB and 20(3) no. 6 KAGB so that UCITS and AIFM may also provide pre-marketing for investment funds managed by other AIFM as part of their permitted ancillary activities. The restrictions on pre-marketing apply irrespective of whether the AIFM or a third party carry out the pre-marketing (cf. draft section 306b(6) sentence 2 KAGB).

It follows that only licensed entities – either the above listed eligible third parties for AIF managed by another AIFM or the authorised AIFM for its own AIF – shall be able to engage in pre-marketing. Although in line with the wording of Directive (EU) 2019/1160, this introduction of a licencing requirement raises concerns regarding market access for new entrants. At the same time, it is surprising and arguably not proportionate that the acquisition of shares or units upon pre-marketing becomes practically impossible and pre-marketing shall still only be open to licensed entities. One would have expected that pre-marketing could be an instrument to test the market before undergoing a long and expensive licensing process.

It is unclear whether small AIFMs which are registered for managing special AIF pursuant to section 44 in conjunction with section 2(4) KAGB, respectively, would be subject to the pre-marketing rules. Like the other marketing provisions of the KAGB, section 306b(1) KAGB, which allows and regulates pre-marketing, is not referenced as one of the provisions applicable to small AIFMs in section 2(4) KAGB. However, according to BaFin's current administrative practice, registered AIFMs within the meaning of section 2(4) KAGB may market the special AIFs they manage to professional and semi-professional investors without being required to comply with the marketing rules based on the argument that the relevant provisions (sections 293 KAGB et seq.) do not apply. Following BaFin's approach to marketing more generally, small AIFM managing special AIF should be permitted to also engage in pre-marketing without being obligated to comply with the requirements of section 306b KAGB.

Notification procedure for pre-marketing

Both pre-marketing by domestic and EU AIFM as well as foreign investment management companies will be subject to a notification procedure.

As provided by draft section 306b(3) KAGB, which transposes Article 30a(2) subparagraph 3 AIFMD, the commencement of pre-marketing by a German AIFM shall be notified to BaFin within two weeks of it having begun pre-marketing. The notification letter shall specify the Member States in which, and the periods during which, the pre-marketing is taking or has taken place, a brief description of the pre-marketing including information on the investment strategies presented and, where relevant, a list of the AIFs and compartments of AIFs which are or were the subject of pre-marketing (cf. draft section 306b(3) sentence 2 KAGB which transposes Article 30a(2) subparagraph 3 sentence 1 AIFMD). Thus, AIFM need to document their pre-marketing activities in order to fulfil these notification requirements.

BaFin would then be required to promptly inform the competent supervisory authorities of the EU Member States in which pre-marketing has taken place or is taking

place (draft section 306b(3) sentence 3 KAGB). The competent authorities of the Member State in which pre-marketing is taking or has taken place may subsequently request BaFin to provide further information on the pre-marketing that is taking or has taken place on its territory (draft section 306b(3) sentence 4). A notification of pre-marketing in Germany as Home Member State would therefore suffice to carry out pre-marketing throughout the EU.

A similar notification procedure will apply to pre-marketing of non-EU AIFM in Germany (draft section 306b(4) KAGB). This notification is not explicitly required by the AIFMD as the pre-marketing rules only refer to EU AIFM. Accordingly, the Draft Bill does not provide for a pre-marketing passport and mutual information exchange procedure between supervisory authorities for pre-marketing of non-EU management companies. Nevertheless, the introduction of this notification procedure is consistent with the EU legislator's intention to prevent Member States from putting EU AIFMs at a disadvantage vis-à-vis non-EU AIFM (cf. recital 12 of Directive (EU) 2019/1160). Pursuant to Article 69a AIFMD, the EU legislator reserved the extension of the passport regime for pre-marketing to non-EU AIFM for a later review.

Reverse Solicitation

The introduction of rules on pre-marketing shall, according to the German legislator, have no effect on the recognition of reverse solicitation. According to the explanatory notes to draft section 1(1) no. 29a KAGB, *"[it follows] from the definition [of pre-marketing] that pre-marketing is initiated by the management company or on its behalf. If the potential investor takes the initiative to acquire shares or units of a fund (so-called reverse solicitation), it is neither distribution nor pre-marketing"*. This corresponds to the legal situation in respect of marketing, pursuant to which marketing activities vis-á-vis professional and semi-professional investors shall only be considered to constitute marketing if they take place at the initiative of the management company or on its behalf (section 293(1) sent. 3 KAGB). Accordingly, if professional or semi-professional investors subscribe at their own initiative for units or shares in special AIF which were subject to pre-marketing, this should generally not be regarded the result of marketing of that AIF.

However, the interplay between reverse solicitation and the above-mentioned 'blocking period' of 18 months, during which any subscription is deemed to be the result of marketing, is not entirely clear. On a strict textual reading, this could be interpreted to mean that reverse solicitation is not possible during this 18-months period. Yet, there would be good arguments to assume that it is both the German and the EU legislator's intent to apply the presumption of pre-marketing only to investors to whom the AIF was actually pre-marketed, and to allow AIFMs to rely on reverse solicitation with respect to other investors. This finds support in the legislative process of the Directive (EU) 2019/1160. The following statement in recital 11 of the Commission's draft of Directive (EU) 2019/1160 was not included in the final Directive: *"However, when following the pre-marketing activities the AIFM offers for subscription units or shares of an AIF with the features akin to the pre-marketed investment idea, the appropriate marketing notification procedure should be observed and the AIFM should not be able to invoke reverse solicitation."* Instead, the EU legislator included the following in recital 10 of the final Directive (EU) 2019/1160: "*EU AIFMs should ensure that investors do not acquire units or shares in an AIF through pre-marketing and 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."* On that basis, it seems reasonable to argue that the marketing presumption in draft section 306b(2) sentence 2 KAGB should not apply to those investors who were not contacted in the course of pre-marketing activities and subsequently subscribe for the units or shares of the relevant AIF at their own initiative. This interpretation appears preferable and appropriate, as it is a long-standing principle of EU and German law that the passive freedom to provide services is generally guaranteed. However, since there is some residual uncertainty, it would be helpful if BaFin confirms this interpretation when it revisits its FAQ on the distribution and acquisition of investment funds.

What seems clearer with regard to reverse solicitation is that reverse solicitation is not excluded where the AIFM merely conducted pure capability marketing. This follows from the explanatory memorandum of the Draft Bill, according to which it may be deduced from the definition of pre-marketing that the *"mere advertising of its own capabilities by an AIFM [...] does not lead to the exclusion of reverse solicitation"*.

Conclusion

The FoG will have a significant impact on the marketing of AIF to both professional and semi-professional investors in Germany. Not only will it substantially broaden the scope of applicability of the marketing provisions in the context of special AIF, but it will also bring a novel notification and licensing requirement for pre-marketing which will have far-reaching consequences for investors who would like to test investment strategies in the market. In addition, the legislative materials include some helpful clarifications on the implications of capability marketing.

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