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Changes for Real Estate Funds

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On 11 February 2011, after a second and third reading, the German Parliament (*Deutscher Bundestag)* passed the Investor Protection and Functionality Improvement Act (*Gesetz zur Stärkung des Anlegerschutzes und Verbesserung der Funktionsfähigkeit des Kapitalmarktes*, **"AnsFuG"**). The real estate fund sector had been following this with great interest, particularly because of the changes made to the provisions on open-ended real estate funds (**"real estate funds"**) in the German Investment Act (*Investmentgessetz*, **"InvG"**).

1. Borrowing limit

While many points in the act passed by the German Parliament remain unchanged from the government draft, or include only minor changes, a new debt ratio proposed by the Financial Committee of the German Parliament has now been introduced for real estate funds. Instead of allowing up to 50% of the real estate value to be debt financed, borrowing at the level of the real estate fund will be limited to 30% in the future.

2. Minimum holding periods

Even though minimum holding periods were discussed a number of times, generating a great deal of controversy, AnsFuG is now introducing a 24-month holding period. The burden of proof is on the investor to show that a quantity of units equal to the number being redeemed was held by him continuously for a period of at least 24 months. An exemption is made for up to EUR 30,000 in redemptions per investor each half calendar year. This is mainly intended to provide private investors with the flexibility they need when making investments, and to ensure that real estate funds remain an attractive investment product.

If you would like to know more about the subjects covered in this publication or our services, please contact:

Dr. Sven Zeller +49 69 7199 1280

Anja Breilmann +49 69 7199 3117

Dr. Alexandra Uhl +49 69 7199 3154

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance, Mainzer Landstraße 46,
60325 Frankfurt am Main, Germany
www.cliffordchance.com

In order to improve liquidity management, investment management companies (*Kapitalanlagegesellschaften*, "**KAGs**") can also specify the frequency of redemption dates in the fund rules. There must, however, be at least one redemption date every 12 months. Even though the government draft still provided for mandatory redemption charges for fund units that had not been held for at least 48 months and exceeded the planned redemption amount of EUR 5,000 per month, the German Parliament has now decided, similar to the discussion draft, that there should be mandatory notice periods. Redemption orders that exceed EUR 30,000 per half calendar year must be submitted with an irrevocable redemption declaration and a notice period of 12 months. The planned minimum holding period of 24 months and the 12-month notice period are, however, not cumulative. This means that a redemption declaration may already be submitted after a holding period of 12 months, and then fulfilled 12 months later.

The provisions above do now also apply to redemptions for the account of a balanced fund whose fund rules permit it to invest more than 50% of its value in open ended real estate funds. Although this provision was not included in the government draft, it is welcome, as it addresses concerns that the new holding and notice periods could jeopardize those funds of funds, which still need to provide redemption at any time. It is unclear, however, whether the exemption will also apply to foreign funds of funds and German institutional funds.

3. Expert Valuations

Real estate assets of an investment fund have to be re-evaluated at least every 12 months. If redemption dates are less than 12 months apart, the period between the new valuations of each real estate asset cannot be longer than the period between two redemption dates. As the government draft received particularly strong criticism on this point, re-valuations are not required more frequently than once per quarter now, even in the case of daily redemption dates. Further, at every valuation date, the valuation date of no more than 30% of the real estate assets (based upon the most recently determined market value) can be further in the past than a third of the period between two redemption dates.

4. Distributions

As investors will, in the future, be bound for a longer period of time to their investment in a real estate fund, the German Parliament considers it necessary that real estate funds should no longer be in a position to accumulate all income. Accumulating real estate funds are now also requested to distribute to investors at least 50% of the net result available for distribution. A distribution may only be omitted if the profits in question are needed for future maintenance. Since gains on disposals are not considered to be earnings for the purposes of this provision, distributions of capital continue to be unnecessary, as before.

5. Suspension of redemptions

The procedure with respect to suspension of redemptions has remained largely unchanged since the discussion draft of May 2010, and can still be divided into three phases:

Phase 1:
The KAG can suspend redemption twice for six months – altogether a year.

If at a redemption date, redemption requests are received exceeding the real estate fund's available liquidity, the KAG has to suspend redemption for six months. During this time, the KAG should attempt to built-up sufficient liquidity in order to be able to fulfil the redemption requests. If following the expiration of the first six months, redemption is still not possible, the KAG has to suspend redemption for another six months. During these six months, the KAG is required to attempt to build-up sufficient liquidity by disposing of real estate assets, even if these real estate assets were initially not envisaged as being for disposal. The KAG may only accept disposal prices, which are either not, or are only marginally, below the value determined by the real estate experts.

Insofar as after the expiration of these 12 months, there is still not sufficient liquidity available in order to meet the redemption requests, the KAG must move on to Phase 2.

Phase 2:
The KAG can suspend redemption for another 12 months.

During this time, the KAG must secure liquidity by disposing of further assets. In so doing, a discount of up to 10% of the value set down by the real estate experts is permissible.

If following the expiration of these further 12 months redemption is still not possible, the KAG has to move on to Phase 3.

Phase 3:
The KAG can suspend redemption for another six months.

During this time, it must secure liquidity by disposing of assets at an increased discount of up to 20% off the value determined by the real estate experts.

Insofar as following the expiry of Phases 1 to 3 there is still not adequate liquidity to fulfil all redemption requests, the KAG is to lose its powers of management over the affected real estate fund. The powers of management are transferred to the custodian bank (*Depotbank*), who is to liquidate the real estate fund. The powers of management are also transferred to the custodian bank if the KAG has suspended redemption of units three times within five years, not including suspension of redemptions under section 37 para 2 of the InvG.

At least 3 months or two redemption dates must lie between two suspensions of redemption. However, it is still unclear what is to be done if, due to insufficient liquidity, there are not 3 months or 2 redemption dates between two suspension of redemption decisions. The legislator appears to assume that another suspension of redemption would not be permitted, in which case the KAG could only terminate management of the real estate fund and suspend redemption under section 37 para 2 of the InvG in order to liquidate the fund.

The act also provides for this type of suspension of redemption as standard procedure if a KAG terminates management of a real estate fund.

6. Liquidation of open-ended real estate funds

The AnsFuG is also unclear on the point of whether the custodian bank is actually supposed to undertake the winding up of the real estate fund on its own. A higher level of professional knowledge clearly lies with the KAGs and therefore it does not really seem desirable that the custodian bank alone handles the winding up. In the final analysis, the right to liquidate the real estate fund still remains with the KAG, even if it terminates management of the fund. Further, there is then no control by an independent body. It is also unclear whether the winding up must occur in such a way that a disposal of the real estate assets can only occur at certain values set down by the real estate experts or whether this can occur at the discounted values set out in Phases 1 to 3.

7. Investor right of codetermination

The German Parliament has retained the investor right of co-determination during Phase 1 of a redemption suspension. In the future, investors will be able to exercise certain rights to have a say in the disposal of real estate assets. They are able to agree that real estate assets of the real estate fund can be sold outside the conditions stipulated in section 81 para 1 sent 3 of the InvG. However, this requires at least 30% of the investors to vote at all. The investors must then agree in writing to the disposal of an asset under the value set down by the real estate experts. The 30% threshold is supposed to ensure that the interests of those investors who continue to be interested in an investment in the real estate fund are protected. On the other hand, those investors who have requested redemption should not be overly burdened, in that the quorum is set too high.

This type of "voice" for investors is singular amongst German regulated investment funds, as these are not organised according to company law principles. The only exception has, until now, been the investment stock corporation (*Investmentaktiengesellschaft* – "**InvAG**"). However, a real estate fund cannot have the form of an InvAG and additionally, the rights of an investor of an InvAG to have a say are severely restricted, as only the founding unitholders are permitted to vote on the investment strategy and other fundamental concepts of the fund.

The German Parliament has retained the investor right of co-determination during Phase 1 of a redemption.

8. Termination of management by the KAG

Termination of management by the KAG results in a suspension of redemption for at least six months. During this period, the KAG is to be required to dispose of the real estate assets of the real estate fund for appropriate prices. Insofar as redemption has been suspended because the KAG has given notice of termination or extraordinary market circumstances exist, the prohibition on disposing of real estate assets to group companies of the KAG does not apply. Further, the KAG (and later the custodian bank) will no longer, during the winding up, be required to adhere to the diversification requirements of section 74 of the InvG. Additionally, investors are to receive semi-annual advance payments from the disposal proceeds, insofar as these are not required for ordinary running costs. In this manner, the real estate fund is to be run down and wound-up.

9. Transitional periods

As the transitional periods proposed in the discussion draft and government draft were considered to be unreasonably short, the German Parliament has now decided on the following transitional periods:

The fund rules of real estate funds already in existence when the new act enters into force do not need to be amended before 31 December 2012. In fact, the provisions on investor codetermination rights and the mandatory suspension of redemption after termination of management by the KAG may only be introduced after 31 December 2013. Real estate funds with unit redemption suspended on 31 December 2012, meaning that they cannot amend their fund rules, have a period of six months to amend their fund rules after redemption is resumed.

With respect to the change in the debt ratio, the act provides for a transitional phase extending to December 2014. Real estate funds in existence at the time the act enters into force are only required to adjust their debt ratios by the end of this period.

Investors holding units in a real estate fund at the time the act comes into effect are not required to observe a minimum investment period. The 12-month redemption notice period does, however, apply to existing investors once the fund rules of a fund have been amended.

No separate transitional provisions exist for the revised appraisal system.

10. Consequences for institutional investors

The new provisions could, in principle, also apply to institutional real estate funds (*Immobilien-Spezialfonds*).

However, since these funds can deviate from the provisions for open-ended real estate funds given investor approval, they are not forced to adhere to the new provisions for real estate funds.

Some of the areas where deviation from these provisions is possible given investor consent are as follows:

- Debt ratio: up to 50%,
- no minimum holding periods, and
- 12-month termination notice period can be extended or reduced.

It is expected that insurance companies will only be able to make new investments in institutional real estate funds in the future, and only in case the fund rules of the funds allow redemption at least once every six months.

11. Outlook

Although the Federal Council of Germany (*Deutscher Bundesrat)* now needs to debate the act again, it is expected that it will be passed. The act could then come into force at the end of the first quarter or beginning of the second quarter of 2011.