

# The new investment intermediary and investment product law

The Bill to amend the investment intermediary and investment product law (*Finanzanlagenvermittler- und Vermögensanlagenrecht*, "**FinVermG**") adopted by the Federal Parliament (*Bundestag*) on 27 October 2011 was published in the Federal Law Gazette (*Bundesgesetzblatt*) on 12 December 2011. The Bill will subject further products from the area of the grey capital market to state regulation, in particular through the introduction of additional bases for liability as well as authorisation requirements and a code of conduct for providers and intermediaries of certain products.

## Authorisation requirements under KWG and GewO

So far, intermediary services regarding and distribution so-called grey market products such as shares in closed-end funds are not regulated, i.e. these products can be distributed without holding a licence by the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, "BaFin"). This is to change now. For that reason, the term "investment product" is newly introduced in the Investment Product Act (*Vermögensanlagengesetz*, "VermAnlG") covering these grey market products. With the FinVermG the German Banking Act (*Kreditwesengesetz*, "KWG") will be amended to the effect that investment products qualify as financial instruments. Subsequently, persons who distribute investment products as institutional intermediaries will, under certain circumstances, need a KWG licence in the future. In contrast to this, independent intermediaries will only have to meet the provisions imposed by the Trade Supervision (*Gewerbeaufsicht*). Nonetheless, special requirements will be imposed under two schemes regarding reliability and qualification of the intermediaries handling investment products to enhance investor protection on the grey capital market in the future.

### Overview

- Investment products are financial instruments within the meaning of the KWG and the WpHG
- Licence requirements for financial investment intermediaries
- Compliance with the MiFID Code of Conduct during distribution
- Information Sheet for investment products becomes mandatory
- Extension of the auditing scope of BaFin in the approval process of sales prospectuses
- Approval of addenda
- Additional minimum information
- Right of revocation after publication of addenda
- Cancellation of the short limitation period for prospectus liability claims
- Additional reporting duties

## Authorisation and exceptions under KWG

According to the new section 1 para 11 sentence 1 of the KWG, investment products within the meaning of section 1 para 2 of the VermAnlG are deemed to be financial instruments. Consequently, this term is extended to the following products which are not securities within the meaning of the German Securities Prospectus Act (*Wertpapierprospektgesetz*, "WpPG"):

- (1) Shares granting participatory rights in respect of the result of a company;
- (2) Shares in assets held or managed by the issuer or a third party on its own behalf for third party account (trust assets);
- (3) Shares in any other closed-end funds;
- (4) Participation rights and
- (5) Registered bonds.

Only shares in a co-operative (*Genossenschaftsanteile*) within the meaning of section 1 of the German Co-operatives Act (*Genossenschaftsgesetz*) are exempted.

A minimum denomination of the financial instruments will be irrelevant in this respect. Due to the extended definition, banking transactions and financial services involving investment products will require a corresponding licence from 1 June 2012 on.

Transitional provisions apply to companies involved in these activities already prior to 1 June 2012. These companies only need the banking license under the KWG because of the extended "financial instruments" definition. They can benefit from a preliminary licence until the final decision of the BaFin on their application, provided that a full application for licence is submitted by 31 December 2012.

Consequently, there is a need for immediate action, as the compilation of application documents is very time-consuming due to different regulatory measures, money laundering regulations and the regulation on the control of shareholdings.

However, since the exemptions under the KWG have likewise been extended, companies providing financial brokerage services, placement and issuing services exclusively for providers or issuers of investment products, remain exempted from the licence requirements in accordance with section 2 para 1 no. 10 and 11, para 6 sentence 1 no. 19 of the KWG. As a result, trust administration and giving

placement guarantees for investment products continue to be exempt from the license requirement. According to the explanatory memorandum, institutional supervision by the BaFin is not necessary for investor protection and would result in a disproportionate burden for many fund providers.

For the same reason, companies providing financial portfolio administration and investment administration exclusively for providers or issuers of investment products are exempted from the licence requirements according to section 2 para 6 sentence 1 no. 20 of the KWG. Consequently, providers and issuing houses as well as managers of private equity funds in general continue not to be subject to a licence requirement under the KWG. According to a controversial assessment by the BaFin, managers of secondary market fund shares do not seem to fall under this exemption because in the view of the BaFin they provide services for investors and not for providers or issuers of investment products.

The exception of section 2 para 6 no. 8 of the KWG covers so-called "independent intermediaries" who provide financial services exclusively by way of investment advice as well as investment and contract brokerage in respect of investment products as well as other financial instruments between customers and institutions and/or issuers. They are exempted from the authorisation requirement under the KWG as long as they do not procure the ownership or possession of financial instruments or shares from customers when providing these financial services.

The regulations in FinVermG adopted by the German legislator go beyond the regulatory framework of the EU Financial Markets Directive (MiFID) and other EU Directives. Exemptions are only considered for some foreign providers.

## New trading licence under section 34f GewO: Requirements in terms of reliability, qualification, sound financial situation and third-party liability insurance

Companies exempted under the exception from the licence requirement under the KWG, regardless of the denomination of the investment products in respect of which they act as intermediaries, fall under the German Trade Code (*Gewerbeordnung*, "GewO"), as amended on 1 January 2013. On that date and six months after the regulations under the KWG, the licence requirement under the GewO enters into force.

According to section 34f para 2 of the GewO, the requirements for obtaining a licence include:

- Reliability (no criminal record during the last five years in respect of property or insolvency offences);
- Sound financial situation (no private insolvency);
- Evidence of a professional third-party liability insurance; and
- Qualification (evidenced by an examination in respect of technical and legal basics and customer counselling).

Employees of the independent intermediary involved in advisory and brokerage services are also subject to the reliability and qualification requirement.

Moreover, according to section 34f para 5 of the GewO independent intermediaries and their employees involved in advisory and brokerage services will have to register upon the commencement of their activity with an "intermediaries register" kept with the Chambers of Industry and Commerce. The information, advice and documentation obligations of the German Securities Trading Act (*Wertpapierhandelsgesetz*, "**WpHG**"), which so far only apply for distribution of financial instruments under the KWG regime, will also apply to independent intermediaries.

Insofar as independent intermediaries are licenced in accordance with section 34c of the GewO on 1 January 2013, they will have to apply by 1 July 2013 for an authorisation in accordance with section 34f of the GewO. In these cases proof of qualification will have to be submitted no later than by 1 January 2015.

Section 157 para 3 of the GewO includes an exemption from the qualification requirement for persons who have acted in an employed or a self-employed capacity as investment advisers or investment brokers without interruption since 1 January 2006 and have an authorisation under section 34c of the GewO (so-called "Old Hands" Regulation).

Supervision is taken over by the Trade Supervisory Offices (*Gewerbeaufsichtsämter*).

Section 34g of the GewO allows for the issue of the Financial Investment Intermediary Regulation (*Finanzanlagenvermittlungsverordnung*, "**FinVermV**"), which specifies, amongst other things, the contents and procedures for the expert qualification examination and the requirements for professional third-party liability insurance. A first discussion draft was already published in June 2011. It is, however, likely to be amended.

## Extended regulation for the distribution of investment products

Since investment products in the future qualify as financial instruments within the meaning of the WpHG, their distribution will be governed by many regulations so far only applying to securities and other financial instruments. Furthermore, the minimum information required in a sales prospectus will be extended and providers will be facing new requirements in the approval and publication process, drafting as well as with regard to addenda. The relevant provisions are governed by the *VermAnlG*; the German Sales Prospectus Act is abolished.

## New Code of Conduct for the distribution of investment products

With the qualification of investment products as financial instruments within the meaning of section 2 para 2b of the WpHG effective, from 1 June 2012 on, companies which provide certain services in respect of investment products will in future also be considered as investment services companies.

The definition of financial instruments in section 2 para 2b of the WpHG exempts, however, shares in co-operatives and non-subordinated registered capital protected bonds with a fixed term and a fixed interest rate, repaid at the full nominal value and issued by a deposit taking institute.

Due to their lack of fungibility, investment products continue not to be securities within the meaning of section 2 para 1 of the WpHG. Since this will in most cases prevent their inclusion in organised markets or admission to a stock exchange, insider provisions, market manipulation rules or notification of voting rights are as a rule not applicable to investment products.

When distributing investment products, the Code of Conduct provisions of section 31 ff. of the WpHG will have to be complied with from 1 June 2012 on. This includes:

- Obligation to provide suitable investor-oriented and object-oriented advice;
- Providing an investment product Information Sheet;
- Keeping of a consultation record; and
- Disclosure of commissions and kick-back provisions.

Furthermore, special organisational requirements have to be fulfilled. Many of these requirements have been specified in the BaFin Circular 4/2010 (WA) on the minimum requirements for the compliance function and additional requirements governing rules of conduct, organisation and transparency pursuant to section 31 ff. of the WpHG for investment services companies (**MaComp**).

Since the WpHG provides for exemptions similar to the KWG, independent intermediaries would not be covered by these requirements. However, corresponding requirements in respect of investment advice and brokerage will be imposed on independent intermediaries in accordance with the FinVermV.

## VermAnlG

As already mentioned, the VermAnlG replaces the WpPG and will be the primary law governing the requirements for public distribution of investment products in Germany. As known before, a sales prospectus has to be prepared and published. It will have to be approved in advance by the BaFin. Exceptions from the WpPG in respect of the scope of application and hence in respect of the sales prospectus requirement are also implemented in the VermAnlG. As already set out in section 8f para 2 of the WpPG with almost the same content, according to section 2 of the VermAnlG, offers will continue to be exempted if:

- The offer covers not more than 20 shares of the same investment product;
- The sales price of the shares offered within a period of 12 months does not exceed a total of EUR 100,000; or
- The price of each offered share amounts to at least EUR 200,000 per investor.

## Obligation to prepare an investment product information sheet

According to section 13 para 1 of the VermAnlG, from 1 June 2012 on, providers of investment products will have to prepare an investment product information sheet ("**Information Sheet**") in addition to the sales prospectus before the commencement of the public offering in Germany. According to section 13 para 2 of the VermAnlG, the Information Sheet may not include more than three A4 pages and will have to cover the essential information in respect of the investment products in a transparent and easily intelligible manner. Section 13 para 2 and 3 of the VermAnlG include a catalogue of minimum information, which the Information Sheet will have to contain.

The investor must be able to understand the information without using additional documents (section 13 para 4 of the VermAnlG); hence, a reference e.g. to the sales prospectus is inadmissible. The information in the Information Sheet will have to be brief and prepared in a mutually intelligible language.

The information must be provided in good faith, has to be unequivocal, may not be misleading and must be in conformity with the relevant parts of the sales prospectus.

The Information Sheet will have to include a note that damages based on the information included in the Information Sheet can only be claimed if the information is misleading, incorrect or not in conformity with the relevant parts of the sales prospectus and if the investment product was acquired during the period of the public offer but not later than two years after the first public offer of the investment products in Germany (section 13 para 3 no. 5 of the VermAnlG).

The Information Sheet will have to be filed with the BaFin prior to the publication of the sales prospectus. If the Information Sheet is not filed in time, the sales prospectus will be approved without the right for publication and commencement of the public offering (section 17 para 2 of the VermAnlG). The BaFin will check the formal requirements for Information Sheets to determine whether the Information Sheet is "eligible" to be filed without conducting a completeness and coherence check as for the approval of the sales prospectus. Obvious errors and contradictions will, however, be mentioned.

The information contained in the Information Sheet will have to be updated during the term of the public offer, if it is incorrect or incompatible with the data in the sales prospectus or if supplementary information is published in an addendum (section 13 para 5 of the VermAnlG).

During this period, an updated version of the Information Sheet will have to be permanently accessible on the website of the provider and kept available at the locations identified in the sales prospectus (section 13 para 5 of the VermAnlG). Updates after the end of the offering period are not necessary.

## Extended minimum information in the sales prospectus

In terms of content there are several additional warning references for investment products and extended minimum information requirements which will have to be taken into account during the preparation of the sales prospectus from 1 June 2012 on. Apart from the provisions of the VermAnlG there are also new provisions in the Investment Product Sales Prospectus Regulation ("**VermVerkProspV**").

The relevant date for compliance with the deadline is the receipt of the application for approval by the BaFin.

Regarding the warning reference, the following has to be taken into account:

- First of all, the cover sheet (the upper part of the envelope of the sales prospectus) may not include any additional information weakening the clear indication that the accuracy of the information in the sales prospectus in terms of content is not subject to the review by the BaFin (section 7 para 2 of the VermAnlG in conjunction with section 2 para 2 sentence 1 of the VermVerkProspV). However, according to the BaFin, pictures may continue to be shown on the cover sheet as long as the information remains legible.
- Furthermore, a highlighted reference in the sales prospectus will have to be included stating that damage claims based on an inaccurate sales prospectus may only be asserted, if the investment product was acquired during the term of the public offering but no later than two years after the first public offer of the investment products in Germany. The term “highlighted reference” is subject to interpretation by the BaFin (section 7 para 2 of the VermAnlG in conjunction with section 2 para 2 sentence 3 of the VermVerkProspV).

The minimum information requirements will be extended including the following:

- Information on liquidity risks, risks involved in the use of leverage as well as risks of a possible third-party financing of the share by the investor has to be included in the prospectus; the maximum risk will have to be highlighted (section 2 para 2 sentence 3 of the VermVerkProspV).
- Any deviating rights of the shareholders of the issuer at the time of preparation of the prospectus will have to be identified, if former shareholders have claims under their shareholding *vis a vis* the issuer (section 4 para 1 no 1a) of the VermVerkProspV).
- Other costs, additional funding obligations as well as the total amount of commissions will have to be clearly identified and highlighted in the prospectus as an absolute amount and a percentage (section 4 para 1 no. 10 - 12 of the VermVerkProspV).
- Other contracts, which are relevant for the investment relationship, such as in particular the resource allocation control agreement, will have to be included (section 4 sentence 2 of the VermVerkProspV).

- Further information about founding shareholders of the issuer and shareholders at the time of preparation of the prospectus as well as members of the executive management or the executive board, supervisory and advisory bodies of the issuer, the trustee and other persons (section 7 and 12 of the VermVerkProspV) will have to be disclosed including the following:

- German and foreign convictions for property offences, infringements of banking and securities supervisory laws;
- rescission of an existing banking licence;
- private insolvency; and
- corporate insolvencies under the executive management of such a person;

With respect to these persons it also will have to be stated, whether they hold shares in the following companies, whether or not and, if the case may be, how they work for them:

- companies instructed with the distribution of the issued investment products;
- companies making available debt to the issuer; and
- companies providing not only minor deliveries or services in connection with the production of the investment object.

These regulations extended by the FinVermG will include not only the providers, but in particular natural and legal persons responsible for the prospectus as well as the trustees, because they have materially influenced the publication or the content of the sales prospectus or the submission or content of the offer in respect of the investment product.

- Further details on the investment strategy and investment policy involving additional declaration requirements in particular regarding blind pool concepts (section 9 para 1 of the VermVerkProspV):
  - the concrete projects for which the net income from the offer is to be used; this includes multi-tiered investment processes to be described in detail;
  - the level of realisation these (direct and indirect) projects reached;
  - whether the net income alone is sufficient (in this connection leverage on the level of the special purpose vehicle or target fund has to be taken into account); and



- the other purposes for which the net income is used (including downstream levels).
- Furthermore, the possibilities of an amendment to the investment strategy or investment policy as well as the necessary procedures will have to be described and the use of derivatives and forward transactions will have to be mentioned (section 9 para 1 of the VermVerkProspV).
- It is also necessary to describe indirectly held investment objects. If the investment object consists as a whole or in part of a share in a company, all assets acquired by such company are deemed to be investment objects (section 9 para 2 no. 1 of the VermVerkProspV).  
Consequently, the statement of source and application of funds has to be broken down into all investment objects on each level; a presentation on a consolidated basis alone is not sufficient but can be added on a voluntary basis.
- Terms and conditions, volume and maturity in respect of equity and debt instruments have to be mentioned, together with the counterparties that have entered into a binding commitment as well as information on the targeted debt ratio and the leverage effects (section 9 para 2 no. 9 of the VermVerkProspV); in this connection the *agio* has to be considered in the calculation.
- An interim overview will have to be presented regardless of whether it has been published before or not; an exception only applies, if no on-balance sheet transactions or transactions recognised in the income statement have taken place until the establishment of the prospectus (section 10 para 1 sentence 1 no 2 of the VermVerkProspV).
- Information about the total compensations for members of the executive management or the executive board, supervisory bodies and advisory boards of the issuer, the trustee and other persons will have to be shown for the past and not only for the last financial year (section 12 para 1 no. 2 of the VermVerkProspV), in particular salaries, profit sharing, expense allowances, insurance payments, commission and ancillary benefits of any kind whatsoever.
- So-called new issuers, who were established less than 18 months ago and for which reduced prospectus requirements apply, will have to include additional financial information into the sales prospectus. The expected assets, financial and earnings position and the budgeted figures of the issuer will have to be included

into the prospectus at least for the current and the following three financial years (section 15 para 1 no. 3 and no. 4 of the VermVerkProspV).

The requirement of an IDW expert report (IDW S4 Standard) to be prepared by a public auditor has been dropped again.

### Extension of the deadlines and competencies of the BaFin during the approval procedure

From 1 June 2012 on, the BaFin will audit sales prospectuses no longer only in terms of completeness but also in terms of coherence and intelligibility (section 8 para 1 of the VermAnlG). It will hence be checked whether the sales prospectus contains no contradictions; given the limited review period, the focus will primarily be on obvious contradictions, such as between the “overview of the offer” and the relevant chapters or financial information. There will be no review of the financial information or a comparison with facts outside the prospectus. Furthermore, the approval procedure will be aligned to the WpPG in terms of terminology. In the future, sales prospectuses will be “approved”; their “publication” is no longer “authorised” as it is actually termed.

Given the extended scope of review, the review period will be adjusted to 20 days after receipt of the full sales prospectus (same as securities prospectuses under the WpPG, see section 8 para 2 and 3 of the VermAnlG). Requests for amendments are to be declared by the BaFin within 10 days; the corresponding amendments have to be integrated in a respectively new replacement version and will have to be identified and highlighted as before. It will be no longer allowed to submit single replacement pages. With each sending of a replacement version the deadline commences anew. Therefore, the approval procedure can theoretically be extended for an unlimited period of time. However, according to the BaFin the reviewers will inform the applicant at an appropriate point in time, if they believe that approval cannot be obtained in the near future.

The procedure applies to all sales prospectuses for which applications for approval are received by the BaFin after 1 June 2012.

### Revision of the publication of the sales prospectus and mandatory investor information

The sales prospectus will have to be published one work-day prior to the public offer, as set out in the current re-

quirement, but it will either have to be published in the Electronic Federal Law Gazette (*Elektronischer Bundesanzeiger*) or kept available for distribution free-of-charge with one of the paying agents specified in the prospectus, which will have to be disclosed in the Electronic Federal Law Gazette (section 9 para 2 of the VermAnlG).

In addition, until 31 December 2014 publications and announcements also will have to be published in a supra-regional official stock exchange gazette.

Whereas so far the provider is only obliged to make reference to and deposit the prospectus, he will have to provide an updated version of an Information Sheet, the sales prospectus, the last published financial statements and the management report in text form or, on request, in paper form to an investor or a person interested in acquiring an investment product at the latter's request during the term of the public offer at any time (section 15 para 1 of the VermAnlG).

The provider will have to submit the Information Sheet in text form investment advisors, investment intermediary, broker or trader in investment products on request.

If the provider sells the investment products through its own distribution, according to section 15 para 2 of the VermAnlG the provider will have to make the Information Sheet and the sales prospectus in an updated version available to an interested person in due time prior to the conclusion of the agreement on request.

Investment services companies as defined in the WpHG, when giving investment advice, will be obliged to provide an Information Sheet to the customer in due time prior to the conclusion of a transaction in investment products (if the provider of the investment product is obliged to prepare an Information Sheet). If there is no obligation to prepare a sales prospectus under VermAnlG, the investor will not have to be provided with an Information Sheet.

### Duty of approval for addenda and rights of revocation

Every material new fact or material inaccuracy regarding the information contained in the sales prospectus which is able to influence the valuation of the investment products and which occurs or manifests after the approval of the prospectus or during the term of the public offering, will have to be published in an addendum to the sales prospectus (section 11 para 1 of the VermAnlG).

Consequently, not only changes of facts to be disclosed under the minimum information requirements will trigger the obligation to prepare an addendum, but also initially existing inaccuracies.

For prospectuses submitted for approval after 1 June 2012, addenda will likewise have to be approved by the BaFin; their publication is governed by the new publication provisions for sales prospectuses.

Another new, yet heavily criticised feature is section 11 para 2 of the VermAnlG, according to which investors who have made a declaration of intent to acquire or subscribe for investment products prior to the publication of an addendum will be able to revoke their declaration of intent within a period of two workdays after the publication of the addendum, provided that the transaction has not yet been completed.

It has been discussed whether the right of revocation can be teleologically reduced in case of addenda which only implement the new financial statements into the prospectus. A final interpretation has not yet been provided by the BaFin.

It is also questionable, whether an average investor can realistically obtain knowledge of an addendum within two workdays after a publication in the Electronic Federal Law Gazette.

## Extended prospectus liability risks for providers of investment products

Under the current legal situation, with regard to liability for inaccurate sales prospectuses, reference is made to the Stock Exchange Act (*Börsengesetz*, "BörsG"). From 1 June 2012 on, the prospectus liability rules for investment products will be set out within the VermAnlG; sections 44 – 47 of the BörsG will be abolished.

The VermAnlG includes liability provisions for inaccurate, incomplete or missing sales prospectuses and for incorrect Information Sheets (sections 20 - 22 of the VermAnlG).

These provisions are closely oriented to the existing provisions in the BörsG and the WpPG. Liability for inaccurate Information Sheets has been newly implemented in section 22 of the VermAnlG. It is noticeable that there are no liabil-

ity provisions for missing or incomplete Information Sheets. This is attributable to the fact that the BaFin does not allow the publication of the prospectus without an Information Sheet being filed. According to the explanatory memorandum, a completeness requirement would lead to Information Sheets being overloaded with information.

The existing six month preclusion period for liability claims will be extended to match the duration of the public offer, but not longer than two years (section 20 para 1 of the VermAnlG). In the future, late subscribers will no longer disadvantaged (which had been criticised before). At the same time it is ensured that liability claims cannot be asserted after the public offer has ended. A highlighted reference regarding the preclusion period will have to be included in the sales prospectus for investor protection. The short period of limitation of section 46 of the BörsG has not been transferred into the VermAnlG.

Investment products, in respect to which no sales prospectus had to be prepared in accordance with section 6 of the VermAnlG, will no longer benefit from the short periods of limitation set out in the (then abolished) section 44 – 47 of the BörsG. For other prospectus liability claims, the regular period of limitation of the German Civil Code (*Bürgerliches Gesetzbuch*) will apply (three years from the end of the year in which the claim has arisen and the creditor obtains knowledge of the circumstances establishing the claim).

## Additional reporting duties

**After the entry into force of the VermAnlG the issuers will have to prepare and publish their financial statements in accordance with the provisions for incorporated entities under the German Commercial Code.**

In accordance with section 23 of the VermAnlG, issuers will have to prepare and submit an annual report to the operator of the Electronic Federal Law Gazette in an electronic format and make it available to investors upon request at the end of each financial year (no later than six months after the end of the financial year). The financial statements and the management report will have to be audited and certified by an external auditor.

All issuers, regardless of their qualification under the Commercial Code, will have to prepare their financial statements in accordance with the provisions for incorporated entities. According to section 23 para 2 of the VermAnlG the annual report also includes a management report, the declaration

of the statutory representative of the issuer and the confirmation by the external auditor.

German issuers and issuers from non-EU States will have to get their financial statements audited and confirmed by a German external auditor elected according to the provisions of the German Commercial Code (*Handelsgesetzbuch*). Issuers from EU Member States will have to include a declaration of equivalence of their external auditor in German language.

The reporting duties will in general apply to all issuers of investment products whose investment products are offered to the public in Germany after 1 June 2012 with regard to financial statements and management reports for the financial year beginning after 31 December 2013.



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