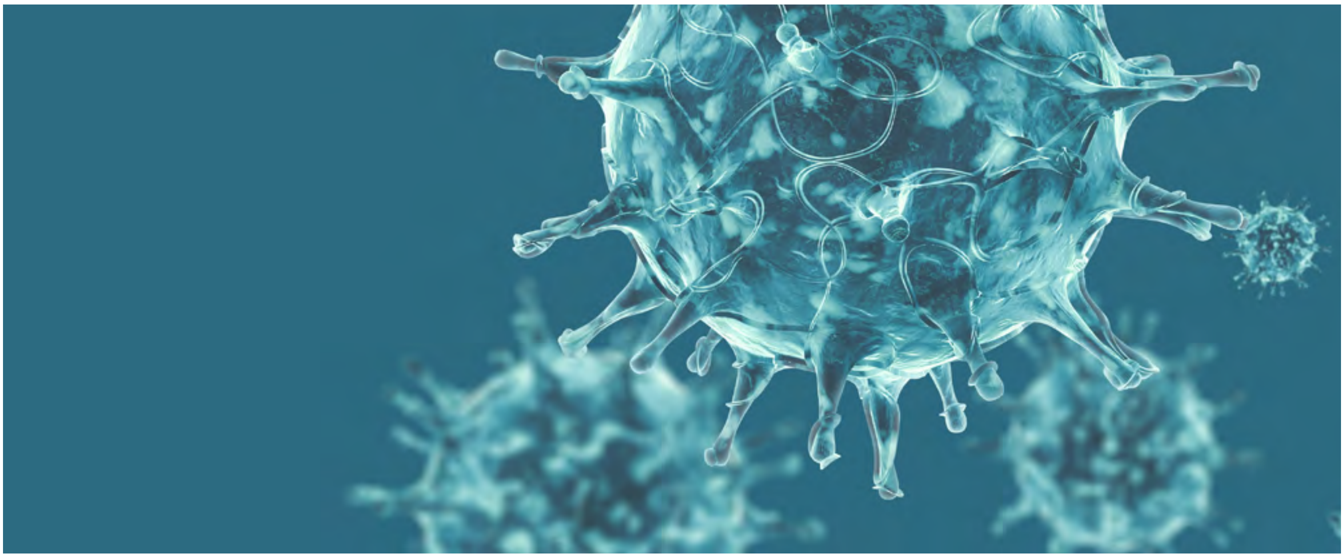
31 March 2020

HENGELER MUELLER



COVID-19

# Update for investment managers during the covid-19 crisis

**CONTENT**


INSTRUMENTS FOR LIQUIDITY MANAGEMENT

PASSIVE INVESTMENT LIMIT VIOLATIONS

CONCLUSION OF TRANSACTION IN THE HOME OFFICE

REPORTING THRESHOLD FOR SHORT-SELLING POSITIONS

CONTACT


The current market distortions caused by the covid-19 pandemic are also presenting investment management companies with major challenges: in many cases, business operations are being maintained on the basis of emergency plans and through home office arrangements. In addition, strongly fluctuating stock market prices have made portfolio allocation more difficult and have led to liquidity risks, which must be managed in the best interests of investors. Managing this crisis, as with all crises, is a top-level issue and is engrossing the entire operational structure.

The German parliament and supervisory authorities have also reacted to the extraordinary market circumstances: firstly, BaFin and ESMA emphasise that investment management companies are to utilise all of the risk and liquidity management instruments already available to them.[1] At the same time, they have granted some relief, for example with regard to passive violations of investment limits and transactions entered into in home offices. Another important step is that investment management companies can now make use of new liquidity management instruments which, together with other planned legislation intended to mitigate the covid-19 crisis, were announced in the Federal Law Gazette on 27 March 2020 and have already come into force.[2]

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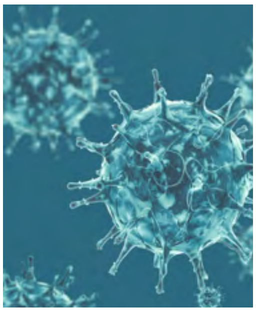
1 ESMA recommends action by financial market participants for COVID-19, 11 March 2020. https://www.esma.europa.eu/press-news/esma-news/esma-recommends-action-financial-market-participants-covid-19-impact

2 Gesetzes zur Einführung von Sondervorschriften für die Sanierung und Abwicklung von zentralen Gegenparteien und zur Anpassung des Wertpapierhandelsgesetzes an die Unterrichtungs- und Nachweispflichten nach den Artikeln 4a und 10 der Verordnung (EU) Nr. 648/2012. http://www.bgbl.de/xaver/bgbl/start.xav?startbk=Bundesanzeiger_BGBl&jumpTo=bgbl120s0529.pdf



CONTENT

INSTRUMENTS FOR LIQUIDITY MANAGEMENT

PASSIVE INVESTMENT LIMIT VIOLATIONS

CONCLUSION OF TRANSACTION IN THE HOME OFFICE

REPORTING THRESHOLD FOR SHORT-SELLING POSITIONS

CONTACT

## 1. Instruments for liquidity management

In Germany, liquidity tools are enshrined in the German Capital Investment Code (KAGB) and were recently expanded by article 5 of the above mentioned amendment legislation. On the one hand, the provisions complement existing liquidity management instruments and, on the other hand, create new instruments which have been available for a long time in other EU countries.[3]

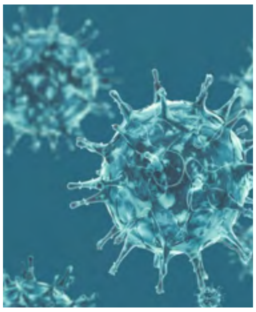
### Which instruments are available to investment management companies for open-ended funds?

— **Redemption gates:** The fulfilment of investors' redemption requests can now be postponed for a short period of time for certain liquid types of funds. This serves the purpose of facilitating effective liquidity management and selling fund assets in an orderly manner. The use of redemption gates is limited to 15 days, provided that redemption requests have exceeded a previously defined threshold above which the redemption requests can no longer be granted in the best interests of all investors due to liquidity situation of the assets. Redemption gates are considered an effective crisis management tool, the use of which is even expected by BaFin. According to reports, there must be compelling reasons if the option of using redemption gates is not stipulated in the fund rules.

— **Redemption notices/redemption periods:** Even before the most recent amendment, the KAGB provided for the option of redeeming units of certain types of funds only on previously determined redemption dates and subject to certain redemption periods. These instruments have now been extended to UCITS, other types of German funds, such as mixed investment funds, and certain special funds for professional and semi-professional investors. The frequency of the permitted redemption dates and the duration of the redemption periods differs according to the specific type of fund: for example, redemption is permitted with a twelve-month notice period for open-ended real estate funds, while a maximum redemption period of one month now applies to UCITS. The determination of redemption dates and notice periods is at the discretion of investment management companies; however, if used, they must be integrated permanently into the liquidity management system. It should also be noted that the units to be redeemed must be blocked by the custodian until they are actually redeemed.

— **Swing pricing:** In the event of an unusually large number of redemption requests, an investment management company may be forced to sell a fund's assets in order to meet its redemption commitments to investors leaving the fund (emergency sales). The newly introduced swing pricing enables investment management companies to take into account the transaction costs associated with the redemption of units and the sale of assets when calculating a unit's value (modified net asset value). For example, the redemption price drops if an unusually large number of investors wishes to redeem their fund units. Swing pricing ensures that transaction costs are distributed among those investors who caused the transaction costs, thereby stabilizing the fund's liquidity management. As part of their organisational duties, investment management companies interested in

3 Eine (nicht aktuelle) Übersicht über die Verfügbarkeit der Liquiditätsmanagementinstrumente in der EU findet sich in den Empfehlungen des Europäischen Ausschusses für Systemrisiken (ESRB/2017/6).
https://www.esrb.europa.eu/pub/pdf/recommendations/esrb.recommendation180214_ESRB_2017_6.en.pdf



CONTENT

INSTRUMENTS FOR LIQUIDITY MANAGEMENT

PASSIVE INVESTMENT LIMIT VIOLATIONS

CONCLUSION OF TRANSACTION IN THE HOME OFFICE

REPORTING THRESHOLD FOR SHORT-SELLING POSITIONS

CONTACT

using swing prices should produce a detailed description of the swing pricing procedure for the fund documentation (e.g. with regard to full or partial swing pricing).

— **Suspension of redemption:** No units may be issued as long as redemption is suspended. The suspension of unit redemption of is considered the 'ultima ratio' in a liquidity crisis and was already possible before the latest change in German law. This instrument can be used by investment management companies and also by BaFin under exceptional circumstances and only if it is justified in the best interests of investors: for example, in the event of stock market closures or if it is no longer possible to determine a unit's value correctly or if assets can only be sold at unreasonable prices. An investment management company must inform investors immediately of the suspension of redemption. However, suspensions can be accompanied by considerable damage to an investment management company's reputation and are often associated with welfare costs for investors as they cannot liquidate their units while the market value of those units continues to drop.

These liquidity management instruments can be structured differently depending on certain thresholds and only apply to certain types of funds. For example, the use of short-term redemption gates is possible for UCITS, mixed investment funds and special funds, while swing pricing is permitted for all types of open-ended funds except for open-ended real estate funds.

**How to implement the new liquidity management instruments?**

Using crisis and liquidity management instruments is at the discretion of the investment management companies. In exercising their discretion, the interests of investors, the investment strategy and the liquidity of the assets must be particularly taken into account.

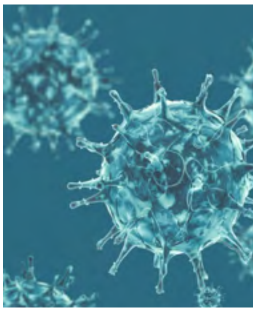
In order to use the new instruments, the fund documentation, in particular the fund rules and the prospectus, must be amended. Depending on the fund structure and the wording of the contractual documents, BaFin's approval and/or other internal resolutions by the advisory board or the supervisory board may be required. In order to ensure seamless implementation, e.g. of redemption gates, investment management companies should coordinate their course of action with depositaries and investors.

Because this process is so time-consuming, the German Investment Funds Association (BVI) and BaFin are currently working together on whether and how to set up a 'fast-tracked approval procedure' for amending fund rules and on drafting model clauses. Although we expect a final announcement on this from BaFin and the BVI soon, the above mentioned liquidity management instruments are already permitted under current law, i.e. investment management companies may begin using them today.

**In our view, the following questions are currently particularly relevant:**

— **Sounding the situation:** Which instruments make sense for which types of funds? What is the legal and contractual framework in the specific fund structure?

— **Deciding to use liquidity instruments:** What are the legal consequences of using certain instruments? Which instruments are primarily expected by supervisory authorities?



CONTENT

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PASSIVE INVESTMENT LIMIT VIOLATIONS

CONCLUSION OF TRANSACTION IN THE HOME OFFICE

REPORTING THRESHOLD FOR SHORT-SELLING POSITIONS

CONTACT

— **Establishing practicability:** What steps first need to be taken to make the instruments practicable and second to actually use them? What specific requirements must be met (changing fund rules and prospectuses, applying with BaFin, informing investors, amending contracts)? What must be coordinated with BaFin, the depositary and, if applicable, the investors?

## 2. Passive investment limit violations – flexible treatment by BaFin

The BVI has reported that in the current situation, BaFin sees room for a flexible approach to passive investment limit violations. Nevertheless, the interests of investors must be safeguarded and limits must be complied with within a reasonable period of up to 20 days.

The background is that exceptional market circumstances may lead some investment management companies to want to change the composition of a fund's portfolio in order to avoid losses for investors. However, the portfolio allocation must adhere to the investment guidelines, and the thresholds stated therein, in principle, may not be exceeded or fallen short of. In this respect, the German Federal Ministry of Finance has indicated – before the current C-19-crisis – that not every breach of investment limits will lead to a loss of an equity or mixed fund's tax privilege (circular of the German Federal Ministry of Finance dated 21 May2019). According to that circular, passive breaches of investment limits will generally be considered immaterial if they occur based on an unintentional or involuntary incorrect classification and if the investment fund takes possible and reasonable measures to restore the required limit or quota immediately after becoming aware of the breach. In this respect, it is to be deemed unobjectionable if an equity or mixed fund falls below the limits on a total of up to 20 individual or consecutive business days in a financial year (20-business-day limit).[4]

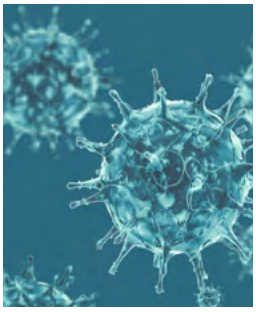
According to reports, passive investment limit violations may be considered unobjectionable by BaFin, while an active investment decision that leads to a violation of investment limits is still not permitted. However, individual cases can be discussed with BaFin, provided that this is possible given the time constraints.

## 3. Transactions may be entered into at home

In its KAMaRisk circular (01/2017), BaFin requires that transactions for the account of an investment fund entered into outside of business premises be permissible only if this is clearly regulated and documented by the investment management company. In the current situation, however, organisational and technical problems can arise if business transactions have to be carried out at short notice and outside of business premises, for example from one's home office.

For this reason, BaFin believes that the strict rules for entering into business transactions can be temporarily relaxed for a home office arrangement due to the crisis. Decentralised workplaces which have been set up by crisis management are generally considered per-

4 BaFin, amended on 30 March 2020 regarding Covid-19: BaFin information on new developments and key points https://www.bafin.de/EN/Aufsicht/CoronaVirus/CoronaVirus_node_en.html



CONTENT

INSTRUMENTS FOR LIQUIDITY MANAGEMENT

PASSIVE INVESTMENT LIMIT VIOLATIONS

CONCLUSION OF TRANSACTION IN THE HOME OFFICE

REPORTING THRESHOLD FOR SHORT-SELLING POSITIONS

CONTACT

missible. In the absence of access to office and business premises, BaFin believes that it is necessary to create an alternative in order to maintain business operations.

In the event that transactions outside of business premises (e.g. in a home office) were previously prohibited under the company's internal policies, such bans should now be expressly lifted. It should then be clearly defined under what conditions a home office arrangement should be allowed and for how long. In addition, investment management companies are obliged to establish an emergency plan for maintaining business operations which includes arrangements for home office working.

## 4. Reporting threshold for short-selling items: 0.1 percent

On 16 March 2020, ESMA decided that net short positions in shares traded on an EU regulated market must be reported to the national NCA, i.e. to BaFin in Germany via the MVP portal, if the position reaches or exceeds 0.1% of the issued share capital. Exceptions apply to market-making or stabilisation activities. ESMA's decision initially applies for a period of three months and is also relevant for investment management companies that manage hedge funds and use short selling techniques. The publication threshold for an announcement via the German Federal Gazette remains unchanged at 0.5 per cent.

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