Sustainable Investment Law—How to Legally Implement Sustainable Standards

Jens Magers

1 Introduction

The challenges at hand are overwhelming. The tasks can certainly not be left to the responsibility of politics only, but one of the world's most influential sectors, finance and business, urgently needs to undergo a change in paradigm. Investors and business people must understand that the commitment to the highest sustainable standards, such as Environment, Social responsibility, Ethical corporate governance (ESG), the Paris Agreement standards and the Sustainable Development Goals of the United Nations (SDG) is crucial in order to stop and reverse the causal chain, which is heading to a collapse of the global system.

We know that capital has been growing exponentially on this planet and most certainly will continue to do so over the coming decades. It is obvious that in view of these circumstances and the fragile situation of our world, capital must be channeled properly in a right, healing direction. So, if as many investors as possible awakened and understood that they have to make an impact, the investment turnaround could be fostered substantially. Understanding in this context is not only intended in the sense of knowing certain facts but at a deep experience-based level, that is, as a result of a whole process which leads to a firm conviction from where one can only act coherently. What is created by such a process is wisdom. And wisdom should be the guiding light for our undertakings.

What we really need is a steady and accelerated evolution toward a profound understanding of the immediate exigencies and anybody is challenged to undergo proper personal development, cultivate love for our planet and a deep compassion for all sentient beings living there. In fact, we have no choice other than to speed up in moving into the right direction. This is fundamental to our survival and that of the global system as a whole.

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Particularly the world's leaders, most influential investors and business people should commit themselves to be trained in order to be able to address the great challenges of humanity. Specialists already offer tailor-made and inspiring leadership transformation training programs that empower the graduates to apply the standards necessary to confront the daunting problems.

Since there is no strict definition of sustainable standards, their content and direction is virtually limitless, for the purpose of this chapter on legal aspects I will consequently speak of sustainable standards, ethical or high-level/superior investment goals in general.

2 Passive Investments

Investors can choose whether they want to be intensively involved in their investments and contribute directly to the success and the implementation of their high-level sustainable investment goals, or not. In the latter case, they may just want to invest capital in order to promote sustainable projects or appropriate companies, without being personally involved all along the investment period.

The distinction between active and passive investments made here is by no means intended to classify active investors higher or more valuable than those, who decide to select the right sustainable investment product and simply invest their money therein. Both categories of investments are important to obtain the overall result of an investment turnaround resulting in a proliferation of companies working in full compliance with the highest standards such as ESG, SDG, Paris agreement and others.

The distinction serves primarily to make the different legal issues more accessible.

2.1 Investment in Mutual Funds

With respect to the passive investment approach, investments in socially and ecologically responsible mutual funds (sustainable funds) are most relevant. During the last decades, many such funds and pooled investment vehicles were created on an international scale. In Germany, however, the number of funds selecting exclusively investments in socially and/or ecologically responsible companies is still limited, but slightly on the rise.

According to the Sustainable Business Institute (SBI), a total of 461 sustainable retail funds were approved for distribution in Germany, Austria and/or Switzerland as of 30 September 2017. These 461 funds were invested with about 90 bn Euros (all

tranches). At the end of 2016, the SBI by way of comparison registered 415 funds that were invested with a total of about 70 bn Euros (all tranches).[1]

The key advantage of an investment in a sustainable fund undoubtedly is that the complex screening work falls into the responsibility of the fund and by the time the investment is made, the selection has already to be completed. This does of course not mean that conscious investors, prior to their investment, will not have a closer look at the fund's selection criteria, due diligence methods, measurements, analytic instruments and reporting tools. In fact, it is highly recommended to make oneself acquainted with the methods applied by the fund.

Details regarding those methods will be discernible from the material the fund will have to disclose to interested investors prior to an investment. As will be explained later, the type of information material (prospectus or other) depends on the type of fund to be launched and its respective addressees.

2.1.1 Legal Framework

In 2011 the European Parliament passed the Alternative Investment Fund Managers Directive 2011/61/EU (AIFMD). This Directive lays down the rules for the authorization, ongoing operation and transparency of the managers of alternative investment funds (AIFMs) which manage and/or market alternative investment funds (AIFs) in the European Union, art. 1 Directive 2011/61/EU.

The AIFMD was a part of a set of measures of the EU to thwart the effects of the financial crisis, which commenced in 2008. The aims of the AIFMD are

- to enhance supervisory practices to prevent market instability and the upcoming of a systemic risk in the European financial system;
- to improve investor protection by imposing new depository standards and enhanced transparency through new investor disclosure rules and strict reporting rules to competent authorities, and
- to promote cross-border competition by deregulating national barriers and creating level playing fields through harmonized rules from 22 July 2013.

It also imposes requirements on third country asset management companies to whom AIFMs delegate portfolio management. Funds which are marketed from third countries into the EU are affected as well.

On 19 December 2012 the European Commission issued the delegated regulation (EU) no 231/2013 (AIFMD level 2 regulation) supplementing the AIFMD regarding exemptions, general operating conditions, depositories, leverage, transparency and supervision.

The AIFMD has been implemented into German national law by the new German Capital Investment Code (Kapitalanlagegesetzbuch, KAGB), that came into force on 22 July 2013. The Code's scope of application is vast, which means that

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[1] von Flotow, Dr. Paschen (2017), market development sustainable investment 3rd quarter 2017, http://www.sustainable-investments.org/news/marktberichte.aspx. Accessed on 4 January 2018.

if an investment fund falls under the definition of the KAGB it must be structured, launched and organized respecting the criteria set out therein, and be managed by a specially authorized management company. If an investment fund is not compliant with these rules, it is considered to be an unauthorized investment business of the management company entailing supervisory provisions as well as, in some cases, criminal prosecution.[2]

The KAGB differentiates between two fund types: *Undertakings for Collective Investment in Transferable Securities* (UCITS) and *Alternative Investment Funds* (AIFs), whereas the definition of UCITS is contained in the UCITS Directive 2014/91/EU, which covers collective investment schemes. The AIF category includes all closed-ended funds and those open-ended funds not defined as UCITS.

UCITS are by definition *public funds* because they are always accessible to private investors. AIFs, however may be structured either as public or as so-called *special funds* because on grounds of the KAGB special funds are only accessible to institutional and other professional or semi-professional investors.

An investor pursuant to § 1 section 19 no. 33 KAGB is considered semi-professional if she undertakes to make a single investment of at least 200,000 Euros and declares by a separate written declaration that she has fully understood the investment risks, and whose investment competence has been explicitly certified by the AIF management company or by the AIF's marketing company, § 1 section 19 no. 33 a KAGB. Alternatively, the Capital Investment Code considers investors to be semi-professional if they invest at least 10 m Euros, § 1 section 19 no 33 lit. c KAGB.

AIFs can be structured as *open-ended* or *closed-ended* funds. According to § 1 section 44 no. 2 KAGB a fund is open-ended, if investors are entitled to ask for redemption of their shares and thus exit the fund before its liquidation period starts (early stage). Sustainable funds as any other private equity or venture capital fund invest in illiquid, tangible assets, and therefore are usually structured as closed-ended funds. The strategical aim is to collect a certain amount of investment capital from a limited number of investors and then close the fund until its liquidation.

The Capital Investment Code imposes compulsory legal structures for funds. Generally, the fund initiators may establish the fund by building so-called special assets in the sense of § 91 and § 92 KAGB. The formulation in § 91 section 1 KAGB is quite misleading, since the term special assets does not define a special legal form but only an internal structure which separates the assets under management from the assets of the management company.[3] The fund's assets fall into the property of the fund management company. Being special assets, however, they have to be kept strictly separate. This structure usually finds application in open-ended real estate funds only.

Alternatively and more commonly, special entities may be founded.

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[2]Weitnauer, Wolfgang (2016), Handbuch Venture Capital, C.H. Beck, p. 55.

[3]Köndgen/Schmies (2017) in Schimansky/Bunte/Lwowski (eds), Bankrechts-Handbuch, C.H. Beck, marginal 100.

In these constellations, closed-ended AIFs may only be launched as investment stock corporations with a fixed capital (Investment-AG) or as closed private limited partnership investment companies (Investment-KG), § 139 KAGB.[4]

Open-ended funds may be constructed as Investment-AGs with variable capital. German national open-ended special AIFs may also be launched in the form of open Investment-KGs.[5]

2.1.2 Fund Management Companies

Funds are managed by a *management company*. This may be an *internal* or an *external* company. If the fund decides to build up a separate management company, special requirements for the implementation of a proper supervisory body apply, § 18 section 2 et seq. KAGB. In Germany for various (also tax) reasons funds in most cases are established with an *external management company*. The typical structure of a venture capital or private equity fund in Germany is that of a GmbH & Co. KG (a limited partnership with a limited liability company as a general partner), where the limited partner assumes the role of the (external) fund management company.

The management company of a sustainable fund has the task to select appropriate targets, do the due diligence work, make the investment decisions, control the observance of the high-level sustainable standards and to manage and monitor the portfolio. Usually a so-called investment committee is appointed to assume the duty of preparing the investment decisions.

A contract between the fund and the management company defines the management company's duties. Such contracts ideally contain explicit guidelines for the screening and monitoring of the portfolio companies. This is particularly important for sustainable fund constructions, where the sustainable standards must be unequivocally, precisely defined establishing rules the management company is obliged to adhere to. The simple reference to ESG, SDG or Paris agreement standards is certainly not sufficient. The management company needs to receive explicit directions on how to determine that a potential portfolio company is apt for and would effectively implement the standards. It is obvious that the mere confirmation by the founders of a potential portfolio company of a commitment to such standards is by far too vague.

The introduction of such a system requires particular know-how and training. A special focus of investors interested in channeling their capital toward an integrally sustainable development will be to verify the fund management company's qualification and its capacities in this respect.

If this type of information is not sufficiently presented in the prospectus or other investment presentation material, I recommend to inquire detailed statements in writing and other suitable supporting documentation.

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[4] Köndgen/Schmies (2017) in Schimansky/Bunte/Lwowski (eds), Bankrechts-Handbuch, C.H. Beck, marginal 99.

[5] For more details see Weitnauer, Wolfgang (2016), Handbuch Venture Capital, C.H. Beck, p 58.

With regard to AIF management companies incorporated in Germany, it needs to be emphasized that the management fees of such companies is subject to VAT, which naturally has caused Germany a significant disadvantage as the base of funds in comparison to other European countries where such fees are exempted from VAT.

This reflects on a larger scale a preoccupying development in Germany concerning the promotion of venture capital investments, which still is not on the same level as in other G20 countries. Incentives would be much needed and surely no further restrictions.

2.1.3 Legal Requirements for AIF Management Companies/Exceptions

Generally, fund management companies are subject to a strict licensing/authorization procedure, § 20 KAGB and further specific requirements, from which AIF management companies are only partly exempted if certain asset management thresholds are respected.

In those cases, the AIF management companies have to apply for registration and comply with the reporting obligations set out in § 44 KAGB only, *unless* they do not opt for a full application of the rules contained in the KAGB applicable to all AIF.

§ 2 section 4 KAGB defines the following conditions and thresholds applicable to *AIF management companies* of *special AIFs*:

- the management company exclusively manages special AIFs;
- the assets under management including assets acquired by using leverage do not exceed the value of 100 m Euros, or without leverage not more than 500 m Euros;

Pursuant to § 2 section 4 lit a KAGB, in case of a *closed-ended public AIF* managed by an *internal* AIF management company the same rules apply, if

- the assets under management of a closed-ended public AIF including assets acquired by using leverage do not exceed the value of 5 m Euros and
- the close-ended AIF public fund has only up to five shareholders.

The thresholds have to be calculated on the basis of the national bookkeeping standards, hence a Germany based AIF management company will have to apply the German bookkeeping standards to assess the value of the assets under its management.[6]

If the AIF management company manages only *closed-ended (also public) AIFs*, § 2 section 5 KAGB offers the opportunity to be exempted from the general strict regulation if

- the AIFM exclusively manages closed-ended AIF funds (also public funds are admitted) and
- the assets under management including those acquired by using leverage do not exceed the value of 100 m Euros.

[6]Weitenauer, Werner (2016), Handbuch Venture Capital, C.H. Beck, p. 60.

This is particularly interesting, because AIFs also acquiring unexperienced private investors (retail investors) in larger numbers (not only a maximum of five like the exception contained in § 2 section 4 lit a described above), may therefore profit from a less severe regulatory system, as well. In those cases, however, for the sake of protection of retail investors more obligations must be observed. AIF management companies along with the registration requirements and reporting obligations mentioned above, simultaneously have to comply with:

- the rules on the approved depositories pursuant to § 80 et seq. KAGB,
- the rules on permitted assets (§ 261 KAGB contains an exclusive list of assets that may be held) and all linked restrictions thereto (contained in § 261 KAGB et seq.) and
- the general distribution regulations set out in § 293 et seq. KAGB.

Therefore, capital investment companies under German law are not allowed to consider all tangible assets when establishing and launching a closed-ended *public* AIF. As we have seen, specific requirements apply also regarding risk diversification and leverage.

2.1.4 Legal Requirements for Fund Management Companies/General Rules

If no exceptional rule applies and/or no opt-in has been submitted, a fund management company is obliged to comply with the whole set of regulations contained in the KAGB.

First of all, it has to undergo the complete licensing procedure and is not entitled to operate before unrestricted obtainment of a license. In this regard it is interesting to know that fund management companies must be established with an initial capital of at least 300,000 Euros in case of an internal fund management company and at least 125,000 Euros in case of an external management company, § 25 section 1 KAGAB.

The license to operate includes the authorization to distribute shares of the fund. The rules for distribution and supervision, however, must be respected. The standards and restrictions alter in accordance with the type of investors the fund intends to address. The highest protection standards, hence, apply when it comes to sell fund shares to retail investors. In this case, the fund management or marketing company has to provide the potential investor with a fund prospectus containing all relevant information, the investment conditions and the articles of association.

Experienced (semi) professional investors, as well have the right to receive all relevant information to the investment, but usually a private placement memorandum as a basis is sufficient. In contrast to retail investors, though, they are for example entitled to receive also the last annual report. § 307 KAGB contains an extensive list of essential details, which have to be given prior to the investment.

The fund management company is further obliged to mandate an official depository according to § 80 et seq. KAGB, which assumes the role of a controller, examining in particular the validity of asset acquisitions and the cash flow.

The German legislator when implementing the AIFMD introduced not only regulations of the fund management companies but also relatively strict rules concerning the investment products. The intensity of the restrictions varies from fund type to fund type, imposing stricter rules if private investors are involved.

Closed-ended special AIFs consequently are subject to lesser limitations than open-ended special AIFs or closed-ended public AIFs. Closed-ended special AIFs for example are not restricted by an exhaustive list of authorized investment assets like closed-ended public AIFs but may acquire every assets the value of which is determinable. Nevertheless, the fund's assets must be evaluated at least on an annual basis.

Pursuant to § 282 section 1 KAGB open-ended special AIF have to respect the rules for the diversification of risks.

2.1.5 Typical Structure of German Sustainable Funds/Relevant Tax Law Aspects

As has been outlined before, sustainable funds like any other venture capital or private equity fund are usually *closed-ended special AIFs* since shareholders should not be entitled to exit the fund before its liquidation period and ask for redemption of their shares. In Germany, such funds are normally established as a GmbH & Co. KG, if the strategic aim is to accumulate the capital of several important investors, then close the fund, do the investments prospected, administer the portfolio companies, foster their value, distribute dividends and liquidate the fund at a defined point in time.

The core management of the fund is assigned to the limited partner, the KG, whereas the general partner, which is the GmbH, takes over all remaining management duties of the fund. The management duties of the management company have already been outlined under Sect. 2.1.2 above.

The shares in the portfolio companies will fall into the property of the GmbH & Co. KG.

One of the main features of this option is that the GmbH & Co. KG is exempted from trade tax, unless its business surpasses the threshold of asset management and is to be regarded as entrepreneurial. The Federal Ministry of Finance on 16.12.2003 published an official letter containing the relevant criteria to avoid the classification of a business as commercial. The rules are complicated and extensive. Therefore, for the purpose of an overview I limit myself to just representing the main aspects:

- acquisitions may not be made by using leverage, provided that bridge loans are allowed,
- dividends resulting from the sale of assets may not be reinvested,
- the management company may not be entrepreneurially active with regard to its portfolio companies. This is the most ambiguous point since the Federal Ministry

of Finance admits on the one hand that the management company exercises its shareholder's rights but on the other hand holds that if the fund for example involves an incubator delivering important counseling services the criterion of exclusive asset management is no longer fulfilled.[7]

This last aspect is of course quite distressing since a proper coaching of a portfolio company, in particular during its initial period of existence is crucial.

Fund initiators may also opt for a corporation. This is usually the case when the strategical intention of the fund initiators is to realize entrepreneurial aims such as reinvesting dividends resulting from the sale of assets, creating a own shareholder value and possibly an exit by an initial public offering (IPO).[8] The Investment-AG seems to be suitable in this regard.

2.1.6 EuVECA, EuSEF, ELTIF

The European Venture Capital Fund (EuVECA), the European Social Entrepreneurs Fund (EuSEF) and the European Long Term Investment Fund (ELTIF) are fruits of broadly based initiatives of the EU. The European Commission in 2010 launched the "Europe 2020 strategy" which is the EU's agenda for growth and jobs for the current decade. It emphasizes smart, sustainable and inclusive growth as a way to overcome the structural weakness in Europe's economy, improve its competitiveness and productivity and underpin a sustainable social market economy. The Europe 2020 strategy is used as a reference framework for activities at EU and national levels.[9]

These Regulations contain special rules for the designated funds, and therefore the KAGB like any other national statutory law is only subsidiary applicable.

In 2011 the Social Business Initiative followed which aims at introducing a short-term action plan to support the development of social enterprises, key stakeholders in the social economy and social innovation as well as at prompting a debate on the avenues to be explored in the medium/long term. The action plan contains eleven priority measures, focusing on the following topics: making it easier for social enterprises to obtain funding, increasing the visibility of social entrepreneurship and making the legal environment friendlier for social enterprises.[10]

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[7] Weitnauer, Wolfgang (2016), Handbuch Venture Capital, C.H. Beck, p 79 containing more detailed information.

[8] Weitnauer, Wolfgang (2016), Handbuch Venture Capital, C.H. Beck, p 72.

[9] For more details see http://www.ec.europe.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/european-semester/framework/europe-2020-strategy_en. Accessed on 7 January 2018.

[10] For more details see: http://www.ec.europe.eu/growth/sectors/socialeconomy/enterprises_de. Accessed on 7 January 2018.

EuVECA

The EU after a thorough market analysis in the end came to the result that venture capital funds stimulate economic growth, contribute to the creation of jobs and capital mobilization, support the establishment and expansion of innovative undertakings, increase investment in research and development and foster entrepreneurship, innovation and competitiveness in general. A common framework of rules regarding the use of the designation EuVECA for qualifying venture capital funds, in particular the composition of the portfolio of funds that operate under that designation, their eligible investment targets, the investment tools they may employ and the categories of investors that are eligible to invest in them by uniform rules in the EU had to be created. It was clear that in the absence of such a common framework there is a risk that Member States take diverging measurements at national levels having a negative impact on the proper functioning of the internal market, since venture capital funds which seek to operate across the EU would be subject to different rules in different Member States, preamble to Regulation (EU) no 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds (EuVECA Regulation).

Hence, the EuVECA Regulation sets the framework for venture capital funds and their managers to opt for its application and to use the designation EuVECA Fund that serves as passport for all member states of the EU (Member States). These are the principal conditions which must be met:

- *a qualifying venture capital fund*, i.e. a collective investment undertaking situated within the territory of a Member State that intends to invest at least 70% of its aggregate capital contributions and uncalled committed assets capital in assets that are qualifying investments, calculated on the basis of amounts investible after deduction of all relevant costs and holdings in cash and cash equivalents, within a time frame laid down in its rules or instruments of incorporation and that does not use more than 30% of its aggregate capital contributions and uncalled committed capital for acquisitions in assets other than qualifying investments; art. 3 section 2 lit. b EuVECA Regulation;
- *a manager of a qualifying venture capital fund*, i.e. a legal person the regular business of which is managing at least one qualifying venture capital fund; art. 3 section 2 lit. c EuVECA Regulation;
- *a qualifying portfolio undertaking*, i.e. a small or medium sized undertaking which does not employ more than 250 persons and that at the time of the investment is not listed and which is not a credit institution, investment firm, financial holding company or an insurance undertaking, art. 3 section 2 lit. d EuVECA Regulation;
- *qualifying investment*, i.e. primarily equity or quasi equity instruments are admitted, art. 3 section 2 lit. e EuVECA Regulation.
- *maximum assets under management*, i.e. the total assets under management must not exceed the threshold of 500 m Euros[11]

[11] Please note that by the time this chapter was written the text of the EuVECA Regulation still contained this maximum threshold. However, the European Institutions on 28 June 2017 reached a

The shares of EuVECA Funds may be marketed to investors which are considered to be professional in accordance with Section I of Annex II to the Directive 2004/39/EC (MiFID) or to investors which under certain conditions are entitled to request to be treated as professional investors pursuant to Section II of Annex II to MiFID or to other investors that commit to investing a minimum of 100,000 Euros and declare in writing in a separate document from the contract that they are aware of the risks associated with the planned investment.

The designation EuVECA gives the EuVECA management company the opportunity to market the shares in all Member States without being obliged to undergo different admission procedures. The principal requirements are, as we have seen, less limiting and far reaching as the rules for AIFs, at least in Germany where the KAGB applies.

EuSEF

By adopting one of the main proposals of the Social Business Initiative the EuSEF was introduced in 2013 with the Regulation (EU) No. 346/2013 of the European Parliament and the Council of 17 April 2013 (EuSEF Regulation).

Qualified fund managers aiming at establishing a social responsible fund may apply for the designation EuSEF. The prerequisites of such an accreditation are, among others, that the fund must be invested for at least 70% in companies that comply with the conditions set out in in the EuSEF Regulation, i.e. social value-added generation, transparent business practices and subordinate profit distribution. Since the principal objective is to have a positive social impact rather than to maximize profits, the EuSEF Regulation only promotes support for qualifying portfolio undertakings that have the achievement of measureable and positive social impact as their focus. Where, on an exceptional basis profits shall be distributed to its shareholders, rules have to be implemented in order to make sure that such distribution of profits does not undermine the primary social objective of the qualifying social portfolio undertaking.

The benefits for social undertakings are only apparent at a second glance. Because what the European Commission wants to achieve with the EuSEF Regulation are uniform standards throughout Europe, in order to designate corresponding funds as transparent and trustworthy for interested investors. The investment market for social entrepreneurship, which is still very reluctant at the moment, is to be made more attractive.

The EuSEF Regulation follows the same basic standards and conditions concerning the establishment, management and marketing of the funds and their managers

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provisional agreement in trilogue on several amendments including the threshold of 500 m Euro; the text of the provisional agreement was adopted by the European Parliament on the 17 September 2017 plenary and by the Council on 9 October 2017. Nonetheless, the amendment (Level 1) of the Regulation itself was still pending.

as those defined by the EuVECA Regulation.[12] The main distinction between the two fund labels is in fact the social impact which has to be followed by EuSEFs, which as a matter of fact requires specific rules.

In this respect, the European lawmaker was wise enough to impose on the mangers of qualifying social entrepreneurships funds to inform their investors prior to the investment decision of the exact positive social target, which is pursued by the investment policy. Furthermore, they are obliged to disclose the methodologies to be used to measure social impacts. This is of course the core information socially responsible investors need.

These and other requirements contained in art. 14 section 1 EuSEF Regulation are complemented by the AIFM's obligation to disclose all information in a clear and not misleading way and to keep it up-to-date and reviewed regularly.

Therefore, the minimum investment also for EuSEFs is 100,000 Euros, which for social responsible funds in particular is rather a high investment threshold.

Market acceptance of EuSEFs but also EuVECA-funds is indeed quite reluctant and this is attributed mainly to the minimum investment threshold for EuSEFs and the maximum assets under management. Interested investors as of today, unfortunately, will find a very limited choice of EuSEF investment possibilities. Hence, the European Parliament on 14 September 2017 decided on amendments to the EuVECA and EuSEF Regulations aiming at improving and simplifying both fund labels by for example lowering the minimum threshold for EuSEF investments to 50,000 Euros. Hopefully, this will make the establishment of EuSEFs and EuVECAs much more attractive.

The positive aspect, in any case is that if a conscious investor finds a EuSEF investment possibility, she can be sure that the fund successfully passed the accreditation procedure and therefore really is committed and obliged to investing in companies that are apt for the social impact purposes defined by the EuSEF Regulation.

ELTIF

The designation ELTIF has been created in order to foster investments in long-term assets such as small and medium-sized enterprises and in the development as well as operation of infrastructure, public buildings, social infrastructure, transport, sustainable energy and communications infrastructure on an EU-wide scale. The Regulation (EU) No. 2015/760 of the European Parliament and the Council of 29 April 2015 on European long-term investment funds (ELTIF Regulation) establishes the minimum requirements which must be met by long-term investment funds to obtain the label ELTIF. The objective of the ELTIF Regulation is to raise and channel capital towards European long-term investments in the real economy, in line with the Union objective of smart, sustainable and inclusive growth, art. 1 section 2 ELTIF Regulation.

[12] For details see 2.1.6.1.

Hence, ELTIFs are surely interesting investment products for ethical investors who are striving to make an impact through their investment, particularly if such funds are mainly invested in social infrastructure and sustainable energy.

Legally these funds have a safe structure. From all the AIFs created by the EU regulations displayed herein, the ELTIF is by far the most strictly regulated one. The EuVECA Regulation and EuSEF Regulation, for example, provide for an authorization mechanism with respect to the AIF only, not also concerning the management company. In deviation therefrom both ELTIF managers and the fund itself must be authorized as ELTIF by the competent authority, i.e. in Germany by the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin). With regard to the AIFM the authorization constitutes the BaFin's approval to manage an ELTIF.

The ELTIF Regulation in derogation from the EuVECA and EuSEF Regulations contains an exhaustive list of *eligible investments*, of which the most relevant are:

- *qualifying portfolio undertakings* which are not collective investment undertakings or financial undertakings and that are either unlisted[13] or listed with a market capitalization of no more than 500 m Euros, art. 10 lit. (e) and art. 11 section 1 lit. (b) ELTIF Regulation;
- *direct holdings or indirect holdings* via qualifying portfolio undertakings of individual real assets with the value of at least 10 m Euros at the time when the expenditure is incurred, art. 10 lit. (e) ELTIF Regulation;
- *units or shares of other ELTIFs*, *EuVECA funds and EuSEFs*, provided that those funds have not themselves invested more than 10% of their capital in ELTIFs, art. 10 lit. (d) ELTIF Regulation;
- *assets which are eligible assets for UCITS*, which may include by way of example equities, bonds, money market instruments and units of other UCITS, art. 9 section 1 lit. (b) ELTIF Regulation;[14]

  The ELTIF exposure to qualifying portfolio undertakings may include:
- *equity or quasi-equity instruments* issued by a portfolio undertaking, art. 10 lit. (a) ELTIF Regulation;
- *debt instruments issued by a qualifying portfolio undertaking*, art, 10 lit. (b) ELTIF Regulation or
- *loans granted by the ELTIF to a qualifying portfolio undertaking* with a maturity no longer than the life of the ELTIF.

It is important to highlight that ELTIFs may enter into securities lending, securities borrowing or any other agreement which has an equivalent economic effect and poses similar risks if thereby not more than 10% of the assets of the ELTIF are affected, art. 9 section 2 lit. (c) ELTIF Regulation. This accounts for the rather secure structure of these funds. This is why ELTIFs may not use financial derivative instruments for other purposes than hedging the risks inherent to other investments of the ELTIF neither, art. 9 section 2 lit. (d) ELITF Regulation.

[13] Not admitted to trading on a regulated market as defined by art. 2 section 18 ELTIF Regulation.

[14] Art. 9 section 1 lit (b) ELTIF Regulation refers to art. 50 section 1 of Directive 2009/65/EC.

Furthermore, ELTIFs are subject to much severer provisions on investment policies than the other European fund structures described under this Section 2.1.6. An ELTIF must invest at least 70% of its capital in *eligible investment assets*, art. 13 section 1 ELTIF. It is entitled to invest up to

- 10% of its capital in instruments issued by, or loans granted to, any single qualifying portfolio undertaking, art. 13 section 2 lit. (a) ELTIF Regulation,
- 10% of its capital directly or indirectly in a single real asset, art. 13 section 2 lit. (b) ELTIF Regulation,
- 10% of its capital in units of any single ELTIF, EuVECA or EuSEF, art. 13 section 2 lit. (c) ELTIF Regulation and
- 5% of its capital in eligible assets for UCITS, where those assets have been issued by any single body, art. 13 section 2 lit. (d) ELTIF Regulation.

Simultaneously, ELTIF cannot acquire more than 25% of the units or shares of a single ELTIF, EuVECA or EuSEF, art. 15 section 1 ELTIF Regulation. The ELTIF may raise the 10% limit on investments in qualifying portfolio undertakings and in individual real assets to 20%. This requires though that the aggregate value of the asset held by the ELTIF in qualifying portfolio undertakings and in individual real assets in which it invests more than 10% of its capital, does not exceed 40% of the value of the capital of the ELTIF, art. 13 section 5 ELTIF Regulation.

Generally, ELTIFs are constructed as closed-ended funds and therefore investors are not entitled to request the redemption of their shares before the end of the life of the ELTIF. Redemptions to investors become possible from the day following the date of the end of the life of the ELTIF, art. 18 section 1 ELTIF Regulation.[15] The life of the ELTIF shall be in line with the long-term nature of it and shall be sufficient in length to cover the life-cycle of each asset, art. 18 section 3 ELTIF Regulation.

ELTIFs are subject to strict transparency and marketing rules. The publication of a prospectus prior to the marketing of the shares or units is mandatory, art. 23 ELTIF Regulation. Such prospectus is required to include all information necessary to enable investors to make an informed assessment regarding the investment proposed to them and, in particular, the risks attached thereto. The main points the prospectus has to contain are:

- a statement setting out how the ELTIF's investment objectives and strategy for achieving those objectives qualify the fund as long-term in nature, art. 23 section 3 lit. (a) ELTIF Regulation;
- the same fundamental information as what has to be disclosed by closed-ended UCIs in accordance with Directive 2003/71/EC and Regulation (EC) No 809/2004, art. 23 section 3 lit. (b) ELTIF Regulation;
- a prominent indication of the categories of assets in which the ELTIF is authorized to invest, art. 23 section 3 lit. (e) ELTIF Regulation;
- a prominent indication of the jurisdiction in which the ELTIF is allowed to invest, art. 23 section 3 lit. (f) ELTIF Regulation;

[15]Under certain conditions premature redemptions are possible. For further details consult art 18 section 2 ELTIF Regulation.

- prominently inform investors about the illiquid nature of the ELTIF, art. 23 section 4 ELTIF Regulation;
- state the specific date for the end of the life of the ELTIF and any right to extend temporarily the life thereof, art. 23 section 4 lit. (b) ELTIF Regulation;
- explain the rights of investors to redeem their investment, art. 23 section 4 lit (d) ELTIF Regulation;
- state the frequency and timing of any distributions of proceeds to investors during the life of the ELTIF, art. 23 section 4 lit. (e) ELTIF Regulation;
- inform investors about the risks related to investing in real assets, including infrastructure, art. 23 section 4 lit. (h) ELTIF Regulation.

Concerning the categories of assets in which the specific ELTIF is allowed to invest, impact investors are recommended to have a close look at the portfolio assets outlined in the prospectus, especially with respect to the selection criteria applied.

The specific feature of ELTIFs is that they may be marketed in their home Member State or in other Member States to professional and *retail investors* likewise. However, where the management company intends to market the ELTIF to retail investors, for protection reasons additional requirements apply, which are even stricter than the rules laid down by the KAGB for German national fund products.

It is worth mentioning for example the requirement of a suitability test: the AIFM when offering shares of an ELTIF to retail investors are obliged to obtain information concerning the retail investor's knowledge and experience in the investment field relevant to the ELTIF, her financial situation, including the investor's faculties to bear losses. Based on the information disclosed, the AIFM of the ELTIF is entitled to recommend the ELTIF to such an investor only if it is suitable for her particularly.[16]

2.2 *Investment in Cooperatives*

There is a great variety of cooperatives with missions focused on environmental, social, cultural and economic impact to invest in worldwide. Such investments, of course, normally are not aimed at maximizing the investment return and consequently are suitable for socially responsible investors who set a focus on supporting select cooperative businesses not counting primarily on the profitability of the investment. Typically, cooperatives are categorized by their branch and function and socially responsible investors may choose which sector is of their interest.

Cooperatives under German law are legal entities, which are owned and in some cases operated by their members, § 17 German Cooperative Societies Act (GenG). Through their membership, the members participate in the profit and loss of the cooperative, § 19 GenG.

Concerning their financing, cooperatives depend on the capital contributions of their members, the membership-fees, further debt and equity investments of their members and in some cases on non-member investments.

[16] For further details consult Chapter V ELTIF Regulation.

At least in Germany it is feasible to admit members who are not interested in making use of the cooperative's products or services and therefore simply want to support the cooperative financially, § 8 section 2 GenG (non-using members). However, it is possible to exclude the voting rights of non-using members completely. One may therefore reasonably doubt as whether cooperatives that make use of this exclusion right could still attract such investors.

So, if a socially responsible investor is interested in fostering a particular cooperative by becoming a non-using member, she is well advised to check on this aspect explicitly.

As far as the cooperative campaigns for new members—whether it be using or non-using members—by itself, it is exempted from the obligations set out in the respective capital market regulations and thus is neither obliged to disclose a prospectus nor a public placement memorandum or other documents prior to the investment. Any acquisition activity in the direction of non-member investors, though, is subject to the capital market regulations.

That is why it is quite complicated for cooperative businesses to cover their ongoing capital needs without incurring high costs for promotion activities for outside investors. The German legislator through a recent reform of the Cooperative Societies Act[17] is trying to give remedy to this difficult situation. The cooperative may now accept member loans in certain limits for the purpose of financing or modernizing property pertaining to its long-term assets.[18]

Since not all cooperatives are likewise suitable to be financed, either because of their particular structure or the availability of collateral, special due diligence is required where specialized technical assistance is crucial.

Every interested investor must know that the investment into a cooperative business by becoming a member is a particular long-term investment, because the member's capital share is not freely marketable, but can only be transferred to other members, § 76 section 1 GenG. Also due to this it is most important to check the respective investment target thoroughly in all respects, legally, technically and of course from the point of view of its sustainable standards.

2.3 Crowdfunding

Crowdfunding, originating from the USA, has become also in Europe a well-known and handy tool for start-ups or companies in their early stage to collect capital via an online platform from a crowd of investors. The advantage of this kind of investment is that the single investor is not exposed to the risk of covering all the financing requirements of a particular start-up, but may participate together with other investors (the crowd) with a relatively little investment at the potential success of the business.

[17] Introduced by the Statutory Law on reducing bureaucracy and promoting transparency in cooperatives, Federal Law Gazette Volume 2017 Part I no. 48, issued in Bonn on 21 July 2017.

[18] Beuthien, Volker Prof. Dr., Zur Genossenschaftsreform (2017), NZG: 1248.

The crowd consequently shares the risk of loss, too. Hence, start-ups can more easily attract investors and satisfy their financing needs.

As attractive as it might seem, from a legal standpoint not every start-up should be apt for crowdfunding, especially because detailed information on the business idea have to be published online. Therefore, in particular complex business ideas, maybe with a high-end scientific background or which require utmost confidentiality, could not be suitable.[19]

As for sustainable investments, today there already exists a good choice of crowdfunding internet platforms focusing on impact investments, which offer exclusively investments in sustainable businesses from sectors such as environment, green energy, green mobility and health.

Impact investors therefore may choose from quite a variety of crowdfunding possibilities and select which sustainable business they would like to support. Usually investors on those platforms will find investment opportunities in the form of *subordinated patriarchal loans*, with a term of at least five to seven years, after which the loan may be terminated annually. In most cases the investor is entitled to terminate the loan extraordinarily in case of a sale of the company. The reimbursement of the loan is normally constructed as if the lender effectively became a shareholder, applying a low interest rate but the investor's entitlement to potential dividends.[20]

Depending on the valuation of the company, every loan amount is allocated a certain quota of participation, which is adjusted in the event of capital increases according to a dilution calculation. In addition to a fixed interest rate, the investor will receive a so-called *bonus interest rate* in case of termination and sale as if she were entitled to participate in the share of the exit proceeds with that rate. With respect to receivables from the loan, be it for repayment or payment of bonus interests, a *qualified subordination* is being agreed so that these receivables may not be claimed if such a claim would lead to a cause for insolvency or if repayment is not possible from unrestricted assets or an annual or liquidation surplus.[21]

Providers are required to respect particular rules aiming at investors' protection. The German legislator after several years of grey investment market without explicit rules made sure that investors obtain all relevant information on the investment and the risks linked thereto.

In 2015 a new law led to the addition of patriarchal loans and subordinated loans to the investments defined in § 1 of the German Capital Investment Act (VermAnlG). Hence, providers of such investments are also subject to the prospectus requirement prescribed in § 6 VermAnlG, unless the prerequisites of the exemptions of § 2 a VermAnlG, which was introduced especially for crowdfunding platforms, are fulfilled:

- investments are exclusively placed by way of investment brokerage via an Internet service platform,

[19] Schmitt, Christoph Dr./Doetsch, Matthias Dr., Crowdfunding: neue Finanzierungsmöglichkeit für die Frühphase innovativer Geschäftsmodelle (2013), BB: 1452.

[20] Schmitt, Christoph Dr./Doetsch, Matthias, Crowdfunding: neue Finanzierungsmöglichkeit für die Frühphase innovativer Geschäftsmodelle (2013), BB: 1453.

[21] Weitnauer, Wolfgang, Handbuch Venture Capital (2016), C.H. Beck, p. 221.

- which is obliged by law or regulation to examine whether the total amount of investments of the same issuer which can be acquired by an investor who is not a corporation does not exceed the following amounts:
  1000 Euros or 10,000 Euros, provided that the investor in question has freely available assets in the form of bank balances and financial instruments of at least 100,000 Euros in accordance with a self-assessment report to be provided by him, or twice the average monthly net income of the investor in question, based on a personal statement to be provided by the investor, but not more than 10,000 Euros.

In case the exemptions apply, providers of patriarchal loans or subordinated loans over an internet platform are only obliged to publish a so-called *investment information sheet*; § 13 VermAnlG. Consequently, also start-ups searching investors through crowdfunding online-platforms are obligated to produce and issue an investment information sheet, which in accordance with § 13 section 3 VermAnlG has to contain amongst others the following basic data:

- investment provider and issuer;
- investment structure and form;
- investment object;
- investment strategy and policy;
- time to maturity, termination period and conditions of interest payment and repayment;
- investment risks;
- prospects for capital repayment and returns;
- fees and commissions.

The investment information sheet must furthermore contain a clear warning in bold letters stating that the investment carries considerable risks and may lead to a complete loss of the assets invested, § 13 section 4 VermAnlG.

Such basic information under investors' protection considerations is crucial and simultaneously puts the investor in the position to assess the investment risks relatively thoroughly.

Concerning the sustainability of the investment, impact investors are recommended an in-depth analysis of the investment object and of the sustainable standards which shall apply, and how these standards are planned to be implemented and their observance be surveyed.

The online service platforms I controlled offered all overviews on the start-up, its business idea and gave access to the business plans, after registration though. The quality of the information in terms of sustainable standards differs significantly. If substantial information is lacking, it is advisable to inquire more details and challenge comprehensive responds from the start-up or the platform providers before placing the investment.

3 Active Investment Approaches

Let us now have a closer look at rather active investment approaches where the investor in comparison to passive investment concepts is much more involved throughout the entire investment period. Investments of this kind require experienced investors who know of the general difficulties of the screening and controlling processes of such investments and who have already accumulated sound negotiating skills.

However, one thing is clear: if conscious investors want to have an impact by leaving a personal signature, they surely will want to be involved directly and not leave the core duties to an investment manager. There is a great number of possibilities to promote sustainable businesses actively. Due to the limited space, I decided to focus on two alternatives, which I consider most relevant.

3.1 Investments in Sustainable Start-Ups

If one intends to influence the change of an entire system, it is generally good to start with the basis and therefore the promotion of young businesses, which commit to sustainable standards, is crucial. In fact, there are many young entrepreneurs thriving to develop business ideas, which follow ecological and ethical standards. But simultaneously it is a complex task to select the right business ideas and determine not only the market value and the profitability of an investment but also whether or not the entrepreneurs behind it have already reached a sufficient level of consciousness to actually implement sustainable standards.

During the selection process, investors will have to analyze the *business plan* before starting an in-depth due diligence. The business plan is the calling card of the target company and the founding partners need to work on it thoroughly and provide detailed information which today is market standard. Therefore, the business plan must contain exhaustive information on the business idea (product and/or technology), the company, the founders or entrepreneurs, the market, on the commercial figures including financial budgeting and, most importantly, on how the implementation of sustainable standards should be realized and secured after the investment. Where intellectual property is involved, the respective (future) intellectual property rights and/or patents have to be described in the business plan as well as how these rights will become part of the company assets and be guaranteed.

If this basic information is missing, it is recommendable not to continue talks with the entrepreneurs behind it, since such an insufficient approach is a clear sign for a lack of reliability on the side of the entrepreneurs, which is needed to make the investment a success. So, even if the target-company should cover the due diligence costs it will most certainly be a waste of time.

Even though the business plan might be convincing, it is highly recommended to hold personal conversations with the entrepreneurs in order to obtain a clear impres-

sion of their personality and integrity and to have comfort regarding the actual implementation of the sustainable targets. Since this is a crucial but simultaneously a very difficult task professional assistance will be required. You will find experts capable of determining the level of consciousness mandatory for the adherence to such high-level sustainable standards on a continuing basis. As mentioned in the introduction, you can also work on your own proficiency in this field by undergoing professional leadership transformation training along with a commitment to a personal development path.

Only if the result of your preliminary evaluations is positive, I advise to proceed with a thorough legal, financial, commercial and business due diligences, which follow market standards.

3.1.1 Important Legal Aspects of Sustainable Start-Up Investments

Start-ups are usually founded in the legal form of a limited liability company (GmbH under German law) and rarely in the form of a stock corporation. The reasons are many, in particular, stock corporations are more regulated than limited liability companies and their foundation involves higher costs, like for example a capital contribution of at least 50,000 Euros, § 7 German Stock Corporation Act (Aktiengesetz—AktG), just to mention one major difference.

Another reason why stock corporations are not the ideal legal form for start-ups is because stocks are admitted to restrictions on their transferability in a limited way only. Since investors should have an interest in establishing regulations that prevent undesired share- or stockholders from entering the company and thereby changing the shareholding proportions, restrictions on transferability are essential. However, if the target company is a stock corporation investors are recommended to make sure that its stock portfolio is exclusively composed of registered stocks as only registered stocks may be restricted in their transferability by a mandatory prior consent of the company, § 68 section 2 AktG.[22]

Shares in a GmbH, by contrast, may be submitted to any kind of restrictions with full legal effect vis-à-vis every third party, § 15 section 5 Limited Liability Companies Act (GmbHG).[23]

The following statements will hence focus on investment targets in the legal form of a *German limited liability company (GmbH)*.

The main concern after a successful due diligence work, which resulted in a vote in favor of an investment, before signing and effectively doing the investment should be to negotiate and secure *fundamental investor's rights*. This includes in particular the investor's rights to obtain access to information and to control the respect and implementation of the investment goals agreed upon with the entrepreneurs.

Three legal documents are of relevance: the *articles of association*, the *investment agreement* and the *shareholders' agreement*.

[22]Hüffer/Koch (eds), Aktiengesetz (2016), C.H. Beck, § 68, marginal 11.

[23]Reichert/Wellert in: Münchener Kommentar GmbHG (2015),C.H. Beck, § 15, marginal 404.

The *articles of association* is the "constitution of the company" and one of the mandatory founding documents of a GmbH, which in accordance with § 3 section 1 GmbHG has to contain at least the following elements:

- the name of the company and its registered office;
- the business object;
- the amount of share capital;
- the number of nominal amounts of the shares that each shareholder receives in return of a contribution to the share capital (capital contribution).

In addition to this obligatory minimum content, § 3 section 2 GmbHG provides for the possibility of agreeing on optional provisions. These are regulations which, although not being mandatory elements of the articles of association, can only be made with effect for and against the company and future members in the articles of association.[24] These optional provisions concern the company's fundaments, its relationship with the company's shareholders and the legal status of its governing bodies, they apply beyond the scope of the parties to the deed of incorporation and, as the constitution of the company, are also relevant for later shareholders and creditors.

All other, not corporative aspects, which not mandatorily have to be contained in the articles of association, should be included in either the investment agreement or the shareholders' agreement since those agreements, unlike the articles of association, do not have to be made public through the Companies' Register.

The *investment agreement* is a contract between the target company and the entrepreneurs on the one hand and the investor on the other where basic agreements between the parties are summarized. The motivation to enter into comprehensive investment agreements is, as has been said, based on the intention to avoid the publication of core covenants in the Companies' Register. The investment agreement therefore contains all aspects, which do not have to be included in the articles of association and are relevant for a successful investment.

One of the primary provisions to be taken into account is the e*ntrepreneurs*' *obligation to increase the capital* of the GmbH and to accept the investor as a shareholder. In German legal writing it is discussed whether or not such agreements are subject to notarization. The prevailing and correct opinion holds that no notarization is required.[25]

However, since the investment agreement should in any case contain (call- and/or put-options) and tag-and/or drag-along clauses which unequivocally require notarization I recommend to notarize the investment agreement in any case.

Considering the importance of the full implementation of the sustainable goals conscious investors cannot accept any compromise whatsoever and therefore have to make sure that they are fully informed at all times on all relevant issues of the business and are entitled to exercise effective controlling rights.

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[24] Wickert in: Münchener Kommentar GmbHG (2015), C.H. Beck, § 3, marginal 3.

[25] Lieder in: Münchener Kommentar GmbHG (2016), C.H. Beck, § 55, marginal 157.

Under German law the liberty to extend the rights of a single shareholder is notable[26] and sustainable investors are well advised to make maximum use of these possibilities. It is for instance indispensable to secure further information rights than those already attributed by statutory law and define them precisely. Furthermore, since start-up investors for different reasons should acquire only minor portion of shares (not more than 25%), they should insist on disproportionate voting rights in order to secure their predominant power in the shareholders' meetings and foster their powerful position by introducing rights of approval to shareholders' resolutions and veto rights.

It is likewise recommended to establish rights to issue instructions vis-à-vis the management. Explicit instructions in some cases might be the only remedy to guarantee the observance of sustainable standards and to push the respective correct managerial action. I advise in any case to define such instruction rights as exactly as feasible. Since the success of a sustainable start-up investment very much depends on the integrity and skills of the management team the investor should moreover be entitled to propose the managing director.

The investor's rights with respect to the management and the shareholders' meeting described above are fundamental for the control of the investment and should therefore be implemented in any sustainable start-up investment. Every investor should be aware of the fact that the intelligent and comprehensive definition of her information rights forms the basis of all the following rights, because only a completely and timely informed investor can avail herself effectively of all the other rights.

At least in Germany, a particular focus should be made on the determination of whether those investor's rights can be included into the investment agreement or mandatorily have to be contained in the articles of association. The reason underlying this advice is that legally there is a distinction between *special benefits* and *special rights*, whereas special rights only have to be included in the statute if assigned in connection with the company's foundation.[27]

The complexity of these legal issues requires in any case expert legal advice. If you should act without legal assistance, which is certainly not market standard, I recommend, in order to be on the safe side, that those rights are integrated in the articles of association. In any case, it is nothing which absolutely has to be kept secret from the public.

The investor is obliged to provide for sufficient equity capital. In most cases the provision of capital will consist in additional payments into the capital reserves of the company or in subordinated loans. As in any other start-up investment, also in sustainable investments, it is advisable to avoid agio-payments and instead opt for alternative financing methods. Particularly during the early stage *convertible loans* are practical instruments.

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[26]Liebscher in: Münchener Kommentar GmbHG (2016), C.H. Beck, § 45, marginal 128.

[27]For more details on the dispute see Wicke in: Münchener Kommentar GmbHG (2016), C.H. Beck, § 3 marginals 118/119; Fastrich in Baumbach/Hueck (eds) (2017), C.H. Beck, § 3 marginals 45/46 and Weitnauer, Wolfgang, Handbuch Venture Capital (2016), C.H. Beck, p. 340.

In any case and for any type of financing tool, I recommend to make use of the market-standard stage financing system which links each further payment to the achievement of particular goals, so-called milestones. It is obvious that this can be, if used intelligently, an effective tool for sustainable investors. The conditions in that case could be directly linked to the achievement of particular sustainable goals or part thereof. It is recommended to make sure that conditions are defined exactly and stipulated in the investment agreement. Their content, of course, differs from case to case but some fundamental aspects should be respected as a rule:

- the next financing step should be strictly linked to the fulfillment of all the conditions defined;
- a deadline should be added;
- the payment should be made subject to the absence of any breaches of guarantees given by the entrepreneurs and other material circumstances which could be regarded adverse to the successful continuation of the business;
- the determination of the fulfillment of all conditions should be delegated to an independent expert, the expertise of which naturally depends on the kind of conditions he or she will have to assess.

If the GmbH has an advisory board, which not always and necessarily has to be the case, particularly during the early stage, the investor should secure her rights of appointment of the members and/or as her interests may be, the right to become a member herself. Especially in the context of sustainable investments, such observers can assume a crucial role by intensifying the control on the management of the company regarding the implementation of the sustainable investment goals.

It is customary that the entrepreneurs or current shareholders provide guarantees on legal and regulatory matters as well as on certain business issues like correctness of financial figures and unrestricted intellectual property rights. Impact investors may evaluate whether it is reasonable to insist on guarantees regarding the sustainable goals pursued by the investment. This is quite theoretical and depends completely on the single case and if these aspects are at all suitable for a guarantee.

Being start-ups it is obvious that the entrepreneurs behind it who are seeking financial support for their business ideas, due to their limited personal fortune will not be in the position to pay for damages incurred in larger amounts. It is nonetheless important to insist on guarantees, in fact from a psychological perspective. It will certainly enhance the commitment of the entrepreneurs to effectively fulfill the undertakings agreed upon with the investor.

Consequently, it is equitable to accept liability caps for the current shareholders.

If the investor wants to obtain at least a certain degree of economic protection for herself, a remedy could be to implement a clause into the investment agreement whereby the current shareholders in the case of a breach of the representations and warranties undertake to resolve in favor of a share capital increase, the so-called *guarantee share capital increase*. The scope of such a capital increase is to adjust the investor's original valuation whereby she underwrote her shares. The technique applied consists in the investor's exclusive right to underwrite so many new shares

in order to economically reach a position as if she had made the investment decision having been fully informed of the correct facts and thus by investing a lower sum.[28]

Further details concerning the relationship between the investor as a new shareholder and the existing shareholders usually are stipulated in a separate *shareholders' agreement*, which in Germany is not subject to publication in the Companies' register. The contents of such an agreement is manifold. It is common to include vote-binding rules especially for amendments to the articles of association, detailed agreements on the business policy, on the distribution of dividends as well as on the composition of the company's bodies and the remuneration of their members.[29] Sometimes the rules guaranteeing the composition of the shareholders such as put- and call options are also to be found in shareholders' agreements and not in the respective investment agreement. There is no strict rule, but in any case investors are recommended to make sure that those regulations are being fixed in one of those agreements.

3.2 Major Stockholding Investments and Shareholder Activism

Great challenges are inspiring and therefore conscious investors will be glad to direct their efforts toward investments of the highest impact. As has been said before, investments in sustainable start-ups are important but it is crucial that we thrive to transform also major stock corporations by improving their existing conditions in an ever more socially and ethically responsible direction. I know that this sounds radical, but frankly speaking, the daunting challenges the world currently is facing require drastic, ambitious actions aiming at reshaping our global industry structures.

Consequently, impact investors having the means and the possibilities to perform high-scale investments should for example consider significant stockholding investments in stock corporations, which as of today do not comply with sustainable standards. It will of course not be easy to determine which corporation could be the suitable investment target and especially how to obtain access to a majority stock portion particularly as an impact investor (since impact investors are more challenging than regular financial investors), but there are different legal alternatives and smart ways that should be analyzed in any case.

So, why is it important to acquire a majority stock portion or at least a significant one? The answer is quite simple. The transformation of a company philosophy and its direction requires power and influence. The main instrument of every stockholder is her *voting rights* which grow with every stock assigned to the stockholder, § 12 German Stock Corporations Act (AktG). Therefore, the more shares one owns the more impact the shareholder has in the general meeting. Alongside with that every stockholder is entitled to inquire during the general meeting detailed information

[28]Weitnauer, Wolfgang, Handbuch Venture Capital (2016), C.H. Beck, p. 357, marginal 141.

[29]Wicke in: Münchener Kommentar, GmbHG (2016), C.H. Beck, § 3 marginal 131.

with regard to the business, provided that such inquiry is reasonable and necessary in order to evaluate a particular aspect contained in the agenda, § 131 section 1 AktG.

Stockholders furthermore may apply for the convocation of the general meeting if the applicants in total represent at least 20% of the corporation's capital, § 122 section 1 AktG. The shareholders representing this amount of shares or proportionately reach the capital amount of 500,000 Euros are likewise entitled to claim that certain topics relating to the business and the corporation be set on the agenda and be published, § 122 section 2 AktG. In these occasions, the shareholders are recommended to see to formulate aspects of far reaching impact and well-elaborated resolution proposals.

In Germany stockholders also have the possibility to invite the other shareholders in a specially dedicated section of the Bundesanzeiger (which is the official publication of the Federal Republic of Germany published by the Federal Department of Justice and which is comparable to the Federal Register of the USA) to jointly submit a particular motion or to exercise their voting rights during the general meeting in a coordinated way, § 127 a AktG.

There are several further rights which may be used in extreme situations like the general meeting's right to withdraw its confidence in the executive board, § 84 section 4 AktG, but these are all tools for solving really existential issues and are not generally useful as a strategic instrument for stockholders. Impact investors can simply not focus their strategy on such instruments.

Even though the general statutory shareholder rights offer interesting alternatives for impact investors to promote certain ethical goals, they do not really empower to foster a breakthrough in the general business politics of the company; at least it will be difficult to use them for that purpose. One reason is that every initiative pursued to achieve particular ethical or in general sustainable scopes requires a coordinated resolution of the general meeting. And it has always been proven to be difficult to convince other people of one's own ideas. Another reason is that these statutory shareholder's rights are strictly linked to the general meeting and therefore do not give a single shareholder the right to influence the executive board directly and on a more regular basis.

The executive board, at least under German law, is the most important corporate body, since it manages the company and as such is entitled to decide on the most important business matters on a day to day basis, § 76 AktG. Contrary to other legal systems, German corporate law has not implemented a hierarchical structure in the sense that the general meeting is competent to decide generally on fundamental issues or exercise automatically rights of approval and/or veto rights. The general meeting pursuant to § 119 AktG can, in principle, only pass resolutions in the cases expressly determined by law and is not entitled to make decisions on its own initiative or interfere with the competences of other corporate bodies.[30] The same applies to the executive board, since the statutory assignment of the corporate competences in accordance with § 23 section 5 AktG is mandatory.[31]

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[30]See Hoffmann in Spindler/Stilz (eds), Aktiengesetz (2015), C.H. Beck, § 119, marginal 1.

[31]Limmer in Spindler/Stilz (eds), Aktiengesetz (2015), C.H. Beck, § 23, marginals 28, 29.

Therefore, we can hold that in order to have a real impact on the business policy and philosophy it is crucial to be in the position to influence the management effectively.

In recent years a phenomenon called *shareholder activism* became famous which refers to minority shareholders putting pressure on the corporation's management by using their shareholder's rights but also by campaigning through social media, greenmailing etc. Although it cannot be denied that such initiatives often are successful and hence could be used for honorable purposes as well,[32] a more strategic approach, which leads to a lasting transformation of the management in an ethical sense, surely is nonetheless the preferred option.

The acquisition of significant or even majority stock portions automatically entails more power. However, more far reaching competences of the impact investor vis-à-vis the executive board should be negotiated.

In legal practice, several forms of possible agreements between the executive board and an anchor shareholder have become common such as *investor's agreements* and *business combination agreements*.

In most cases the executive board commits itself vis-à-vis the anchor shareholder or future anchor shareholder (as the case may be) to exercise its management competence in a certain way and by doing so accepts restrictions to its comprehensive management rights in accordance with § 76 and § 77 AktG. The investor on his part by way of a tradeoff usually undertakes to follow e.g. the rule not sell her stocks without the consent of the company for a certain time. However, this is not mandatory and the parties may stipulate an exclusive obligation of the executive board only.[33]

For impact investors such an agreement with the stock corporation represented by the executive board—be it an investor's agreement stipulated contemporaneously with the acquisition or a business combination agreement concluded before publication of an offer—is crucial. I recommend making sure that the sustainable standards which in the singular case shall be implemented, are defined unequivocally in detailed guidelines as well as, generally, the suitable management measures which have to be taken along with the implementation. The investor should simultaneously insist on direct information rights to avoid being obliged to inquire relevant facts in the general meeting only.

Likewise important is the investor's rights to obtain direct access to the management in order to express her respective position concerning the defined sustainable goals anytime.

However, especially in Germany investors have to consider some aspects to avoid negative surprises of different kind. As has been explained above, German Stock Corporation law adapted a horizontal structure, which does not assign a superior position to the general meeting. Hence, in legal writing it is disputed whether con-

[32]For more information on shareholder activism see Bunz, Thomas Dr., Vorbereitungs- und Reaktionsmöglichkeiten börsennotierter Unternehmen auf Shareholder Activism (2014) NZG: 1049, who describes the phenomenon from the perspective of the corporations.

[33]Otto, Hans-Jochen Dr., Obligatorische Bindungsverträge zwischen Aktionär und AG-Vorstand über die Ausübung von Mitgliedschaftsrechten und Organkompetenzen (2013), NZG: 934.

tracts containing restrictions to the executive board's management rights are legally valid due to a breach of the mandatory competence structure of the corporate bodies.

To illustrate the core issue, I would like give you the following example:

According to a recent decision of the Landgericht (District Court) Munich confirmed by OLG (Regional Appeal Court) Munich a business combination agreement between the corporation and the controlling company, according to which the executive board may not, without the consent of the controlling company, make use of authorized capital nor may it support the issue of stock options or similar instruments, nor may it sell or acquire any part or all of its own shares or new treasury shares, is incompatible with the division of duties between the executive board and the shareholder, and leads to a reduction in accordance with § 134 BGB (German Civil Code) to nullity.[34] In this ruling, the business combination agreement was stipulated in connection with a controlling and dividends distribution agreement that was impugned by the other shareholders.

This case might be extreme but it illustrates well how the executive board cannot validly renounce to its *essential rights* or commit to binding management measures on *fundamental issues* concerning the corporation.[35] As it seems a prevailing opinion in recent legal writing limits the nullity of such agreements to the cases where the *core of the management rights* is affected, especially where the binding effect is equivalent to a controlling agreement.[36] Reliable case law is missing.

Consequently, the formulation of the commitments of the executive board in an investor's or business combination agreement is a complicated task and a special focus needs to be made thereto. Abstract but still clear wordings avoiding touching the core management rights assigned by statutory law, however still guaranteeing the required influence, are substantial.

Furthermore, it is crucial to avoid that such agreements are stipulated *in connection with a controlling agreement* or trespass the threshold of being interpreted as such. This aspect is of utmost importance since only the assumption of such a legal connection empowers the other shareholders to challenge the resolution of the general meeting approving the controlling agreement due to legal deficiencies of the investor's or business combination agreement.[37]

As you will have noted, there are many smart options to implement a sophisticated structure that empowers conscious investors to make a significant impact. And this is what we urgently need.

[34] Koch in Hüffer/Koch (eds), Aktiengesetz (2016), C.H. Beck, § 76, marginal 41.

[35] Koch in Hüffer/Koch (eds), Aktiengesetz (2016), C.H. Beck, § 76, marginal 27.

[36] Koch in Hüffer/Koch (eds), Aktiengesetz (2016), C.H. Beck, § 76, marginal 41a.

[37] Otto, Hans-Jochen Dr., Obligatorische Bindungsverträge zwischen Aktionär und AG-Vorstand über die Ausübung von Mitgliedschaftsrechten und Organkompetenzen (2013), NZG: 936.

4 Concluding Remarks on the Impact of Artificial Intelligence to Investments

In my opinion, it is impossible to write about Sustainable Investment law or investments in general without making at least some remarks on the challenges caused by Artificial Intelligence (AI). It is clear that AI will arrive on the mass market in the years to come. Many businesses as of today already rely on AI systems in key tasks such as screening, assessing credit worthiness or insurance related issues. Likewise, consumers are already communicating with robots like Siri and Alexa on a daily basis.

As robot technology is evolving on a rapid path and the capacity of AI to make decisions on its own is enhancing, the call for regulation grows. Prominent figures like technology entrepreneur Elon Musk stress the urgency of the matter and highlight the substantial threats connected to robot technology. Mr. Musk even holds that AI represents an "existential threat to humanity".[38]

On the other hand, a report published in 2016 by a Stanford University group founded by Eric Horvitz, a Microsoft researcher, came to the conclusion that "attempts to regulate AI in general would be misguided, since there is no clear definition of AI (it isn't any one thing), and the risks and considerations are very different in different domains".[39]

I disagree. Not that I could already give a solution to this complex issue, but my position as a lawyer is firm. AI of course will have to be subject to the same set of regulations that are applicable to us humans using computers and programming them. Since the application of existing laws is surely not sufficient, tailor made rules must be elaborated which are capable of containing the risks outlined by technology specialists, whilst fostering and certainly not blocking technological progress. All this naturally on a global scale, since a regulation on national levels only would not efficiently confront the risks already individualized.

We certainly cannot leave this task to the tech giants, which apparently have formulated a joint commitment to creating a standard of ethics around the creation of AI,[40] although this is certainly a positive initiative, which is to be appreciated.

Why is all this relevant for impact investors? Impact investors should be interested not only in an ethical conduct of the management of their investment target but also in a technological development, which follows strict ethical rules. But apart from that, there is a simple economic aspect to the issue.

The massive introduction of AI based technical devices will have a fundamental impact on the global economic structure as a whole. Investors generally should therefore have a strong interest in well-drafted regulations of AI, just to secure their

[38]Etzioni, Oren, How to Regulate Artificial Intelligence (2017), The New York Times, 2 September 2017: A 19.

[39]Markoff, John, How Tech Giants Are Devising Real Ethics for Artificial Intelligence (2016), The New York Times, 2 September 2016: B 1.

[40]Markoff, John, How Tech Giants Are Devising Real Ethics for Artificial Intelligence (2016), The New York Times, 2 September 2016: B1.

investments. For impact investors there is also the issue that well selected sustainable investments could become unethical only due to the introduction of an AI device, which for example has not been programmed ethically and therefore does not act accordingly.

Therefore, as a conclusion we should not ask whether AI can be regulated, but how.

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Through his personal commitment to the promotion of the necessary paradigm change in the investment industry where investors strive to achieve the ambitious COP21 and the Sustainable Development Goals of the UN Agenda 2030, Jens began working with socially and environmentally oriented investors and entrepreneurs. He is currently elaborating ways on how best to blend impact into traditional corporate forms, particularly corporations, through use of protective provisions, shareholder agreements and information rights, through language ensuring mission focus and reporting.

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