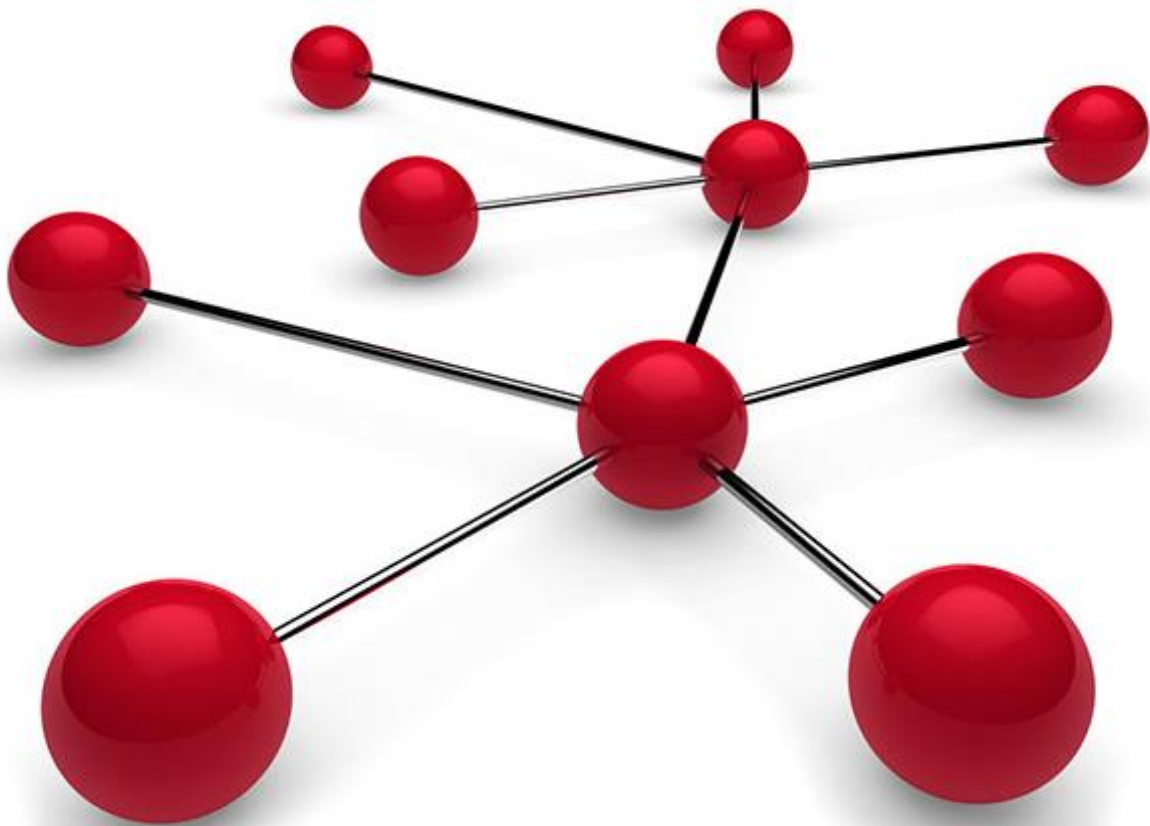


ALLEN & OVERY

Fully
revised
and
updated
version



*The German Super ManCo –
Gain access to German institutional
investors using the German Master-KVG*
January 2017

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Introduction

German institutional investors (banks, family offices, corporates, but most importantly insurance companies and pension funds) are, on the one hand, open to working with non-German asset managers, if such asset managers provide superior expertise and performance in core or satellite investment strategies.

On the other hand, many German institutional investors prefer to invest not into public mutual funds (even if they offer special institutional investor share classes), but into their own, dedicated funds. Moreover, they like to use a structure which gives them the maximum degree of transparency, and the flexibility to change the managers of “their” funds if they are dissatisfied with their performance. Such funds are alternative investment funds (AIF) in accordance with the AIFMD¹ and are often referred to in Germany as “special funds” (*Spezialfonds* or *Spezial-AIF*).

Under German law special funds can be held exclusively by specific institutional investors. Such institutional investors are so-called professional and semi-professional investors.

Over the last decade, a business model has been developed which gives the institutional investor a simple, standardised structure which offers maximum flexibility in terms of manager selection and replacement:

the MASTER-KVG MODEL

Since the implementation of the AIFMD many investment companies in other European jurisdictions have been searching for a set-up where they can manage UCITS and AIFs at the same time – a so-called super management company or simply Super ManCo. Though this business model is pretty new for some of these investment companies, the German Master-KVG has essentially operated as a Super ManCo and already proven itself over the last decades to be an efficient and well-established structure. It is therefore much easier for external asset managers to find a suitable Master-KVG to cooperate with, to meet the external asset manager’s needs and to sell the asset manager’s expertise to German investors.

The Master-KVG model is based on legal documentation which differs from investment management agreements (IMAs) used by Anglo-American asset managers. This client briefing shall help the reader to better understand the general set-up of the Master-KVG model, the legal and regulatory background as well as the obligations asset managers have vis-à-vis their German counterparts.

¹ Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

The general set-up and the parties involved

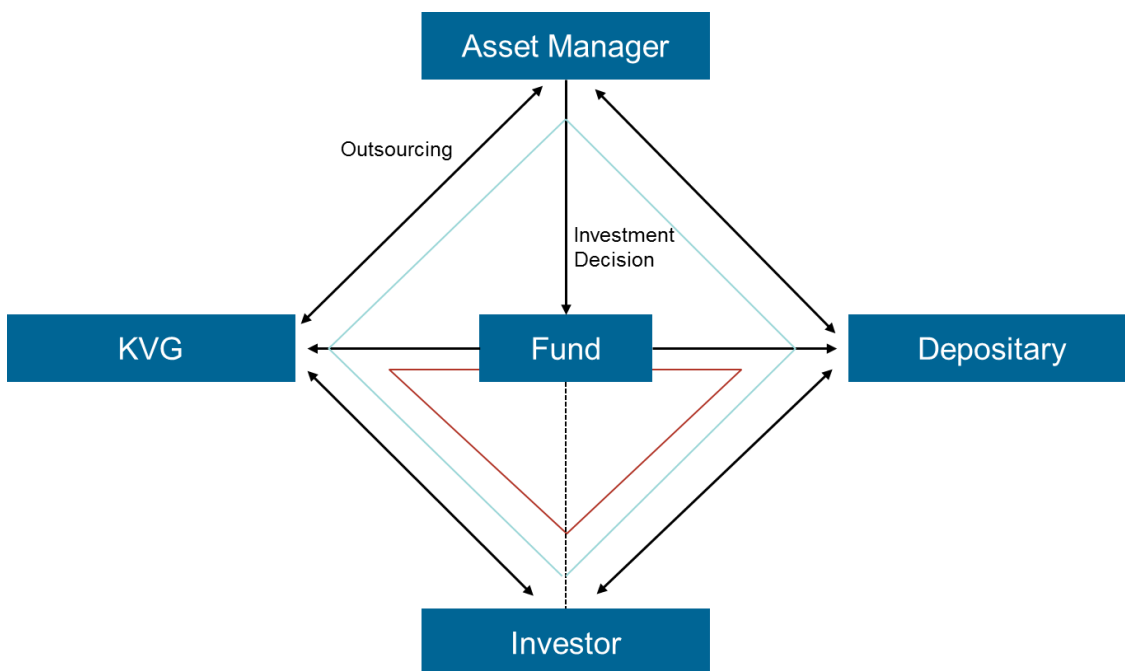
German funds are established on the basis of an investment management contract between the investment management company (*Kapitalverwaltungsgesellschaft – KVG*²), the depositary and the investor. Almost all German funds are established under the contractual model based on the contractual relationship between the investor and the KVG according to the general and special fund rules (*Allgemeine und besondere Anlagebedingungen*). Therefore, the fund itself (sometimes called a separate assets fund, a literal translation of the German term *Sondervermögen* or *Investmentvermögen*) is more or less a blocked account composed of several assets, managed by the KVG and has no legal personality of its own.

The investor invests its money on the basis of the fund rules. In the case of a bespoke “special fund”, the investor, the KVG and the depositary agree in a tripartite agreement (*Dreiervereinbarung*) that the investor subscribes for the fund units.

The KVG is responsible from a regulatory perspective for the administration and the portfolio management of the fund.

The depositary (also known as *Verwahrstelle*³) acts independently of the KVG and solely in the best interests of the investors. In general, it keeps in custody and supervises the fund’s assets in (blocked) accounts or verifies the ownership with regard to the assets which enables the depositary to review and supervise transactions for the account of the respective fund. Furthermore, it issues and redeems the fund units and, in the case of a distributing fund, also ensures the distributions by the fund to the investors in accordance with the applicable fund rules. The calculation of the issuance and redemption price of the fund units is usually carried out in cooperation with the KVG.

The relationship between the investor, the KVG and the depositary is called the **investment triangle** (see red line in the picture below). However, if the asset management and asset allocation of the fund is delegated by a KVG to a third party asset manager, one could consider the result of such modification as an **investment quadrangle** (see blue line in the picture below).

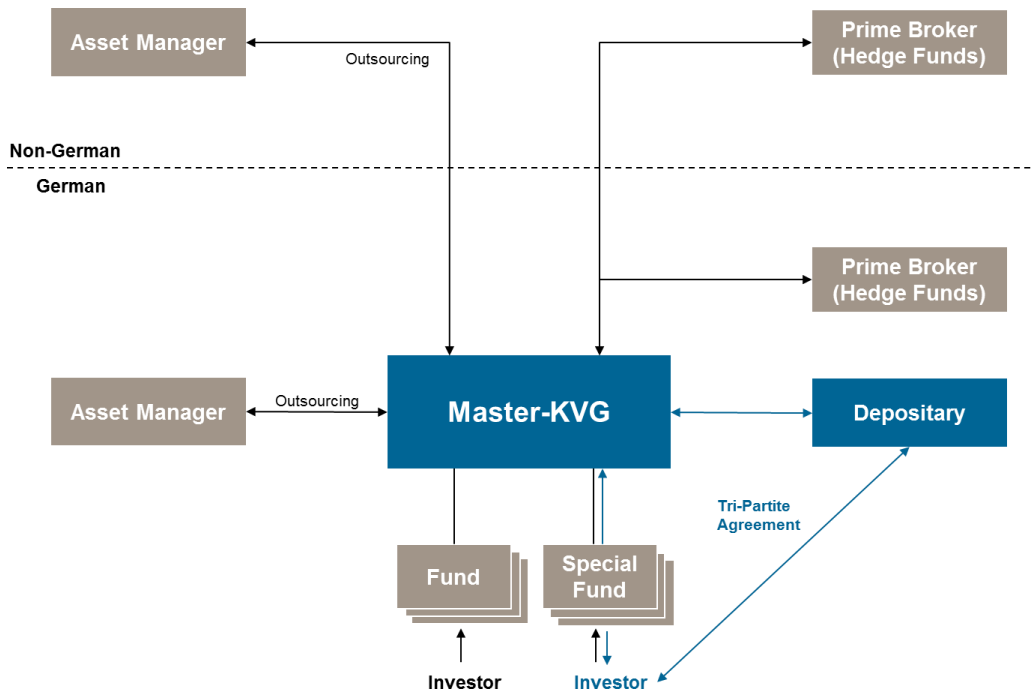


² Before the implementation of the AIFMD the term was “Master-KAG” based on the German term “*Kapitalanlagegesellschaft*”.

³ Before the implementation of the AIFMD this was referred to as “*Depotbank*”.

So how does the Master-KVG model work?

Essentially, you take the so-called investment triangle, consisting of the investor, the KVG and the depositary, and you “bolt on” several German or non-German asset managers to which the portfolio management of a fund or a segment of a fund is delegated / outsourced. In addition, a prime broker may be required if the fund is a hedge fund.



The term “Master-KVG” implies that this KVG is the booking and administration platform for essentially all the investor’s special funds, to maximise transparency and efficiency.

The link between the institutional investor, the Master-KVG and the German or non-German asset manager is an investment management agreement (**IMA**) – also referred to as portfolio management agreement (**PMA**) – which describes in detail the division of labour between the Master-KVG on the one hand and the asset manager on the other.

If you have never worked with a German Master-KVG, getting to grips with the complexities of the contractual documentation – and the underlying rules and regulations – can be challenging, which is why we have tried to give an explanation of the most important aspects of such documentation.

But before we get to the legal topics, let us have a more detailed look at the reasons why Master-KVGs have become so popular among German institutional investors, how the Master-KVG structures work, and who the players are in this market sector.

Reasons why investors use a Master-KVG

The German firm Telos, a research and rating company, conducts a detailed study each year on the Master-KVG market.

The study conducted in 2015 is available in German under the following link:

http://www.telos-rating.de/pdf/TELOS_MasterKVGStudie_2015.pdf

According to respondents of the institutional investors of the November 2015 study, the reasons German investors work with a Master-KVG provider are:

- Central and unified reporting
(cited by 92% of the polled investors; same as in the previous year's study)
- Reduction of administrative burden
(83% which is similar to the previous year's result but only 43% in 2013)
- Improvement of transparency, risk controlling and risk control management
(75%; previous year 58%)
- Risk reporting
(67%; compared to previous year 75% but only 29% in 2013)
- The Master-KVG's ability to provide a 'one-stop shop' of services
(67%, previous year 58%, in future this criteria is expected to become more important)
- Improved comparability of valuation and performance with regard to assets by a standardised data basis
(67%; same as previous year)
- Flexible replacement of an external asset manager
(67%; previous year 58%)
- Clear allocation of competence as well as the avoidance of conflicts of interest
(only 50%; previous year 17%)
- Risk reporting, reporting for insurance companies ("VAG"-reporting⁴)
(17%; same as previous year)
- Overlay management services, cost transparency for management services and for fees, the increase of process reliability due to professionalisation or reduction of interfaces
(25%, 33% and 33%; previous year 25%, 25% and 42%)
- Accounting reasons
(only 17%; previous year 50%)

All of this leads to a situation where around EUR1.3 trillion of assets (previous year EUR1 billion) are managed in special funds of which apparently EUR1tn are held in Master-KVG structures (previous year EUR750bn). This describes an increase of the assets under administration of 33%. However, the market participants do not expect the saturation of the market in near future.

⁴ Reporting in accordance with the German Insurance Supervision Act (*Versicherungsaufsichtsgesetz* – "VAG"); the future reporting under Solvency II will become even more important.

Who are these Master-KVGs?

Some players in the German Master-KVG market are:

- Allianz Global Investors GmbH	- HSBC Internationale Kapitalanlagegesellschaft mbH
- DEKA Investment GmbH	- Metzler Investment GmbH
- Deutsche Asset Management Investment GmbH	- Société Générale Securities Services GmbH
- BNY Mellon Service Kapitalanlage-Gesellschaft mbH	- Universal-Investment-Gesellschaft mbH
- Helaba Invest Kapitalanlagegesellschaft mbH	- HANSAINVEST Hanseatische Investment-GmbH
- Ampega Investment GmbH	- BayernInvest Kapitalanlagegesellschaft mbH
- NORD/LB Asset Management AG	- Institutional Investment-Partners GmbH
- MEAG MUNICH ERGO Kapitalanlagegesellschaft mbH	- IntReal International Real Estate KVG mbH

On average, a Master-KVG charges 4.25 basis points [sic!] for the administration of a fund, and there is immense competition in this market. Other than the Master-KVGs above, there are also some other KVGs that exclusively (or at least as an important element of their business) offer Master-KVG services. Please note that some of the Master-KVGs provide their services as a Master-KVG as an additional business to their existing management of their own investment funds.

Experts have for some time expected a consolidation of this market, but the number of Master-KVGs seems to have grown rather than diminished. However, the market entrance barriers for Master-KVGs have become high due to comprehensive regulation and investor demands. To win more market share, and to distinguish themselves from the rest of the competition, Master-KVGs are offering “Value Added Services” such as IFRS, real time reporting as well as value-at-risk analysis, stress tests, risk management (including risk reporting), transition management and transaction costs analysis. With regard to insurance related reporting, the Solvency II⁵ reporting has become very important for insurance companies. However, these Master-KVGs are also competing with (global) depositaries/custodians which offer similar services, eg reporting services, securities lending and repos as well as overlay management services.

Furthermore, some Master-KVGs are also specialised with regard to certain types of funds such as private equity funds, real estate funds and real asset funds.

Managing German investment funds

Introduction – The role and responsibility of the Master-KVG

If you have never dealt with a German fund before and are trying to understand its structure, the closest equivalent will be the *Fonds commun de placement (FCP)* under Luxembourg or French law. The larger majority of German funds are established under the contractual model where the investor(s), the KVG and the depositary agree contractually that the fund shall be set up. In this case the fund is just a cluster of assets, which has no legal personality.

⁵ Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

Understanding the legal structure of the fund is essential to understanding the legal position of the Master-KVGs, and why they occasionally seem to be rather inflexible in negotiations:

- When a Master-KVG purchases or sells an asset for the fund, it does so in its own name, under its own responsibility and liability. True, it acts for the (joint) account of the investor(s), but legally speaking the KVG is on the hook if things go wrong, eg if a non-eligible asset is purchased for the fund and subsequently resold at a loss. Also, recourse to the KVG is not limited to the assets contained in the fund, so that if, for example, the KVG delegated any of its duties to another asset manager, the KVG in a worst-case scenario could become insolvent, even if the KVG itself followed all legal and contractual requirements. However, this has never happened in over 60 years of KVG (and KAG) history.
- So, when a KVG delegates the portfolio management function to an asset manager, commercially speaking, it acts simply as a fund administration platform, against a small fee. However, from a legal perspective it runs the risk that such asset manager makes a mistake for which the KVG will be liable to third parties and the investor(s). In such a situation, the KVG wants to make sure that it has full recourse against the asset manager, which must under no circumstances be able to “escape” through a contractual loophole.
- The KVG is – particularly under applicable laws and in the eyes of the regulator – still primarily legally responsible for the portfolio management process, even if this task has been fully “delegated” or, better, fully “outsourced” to the asset manager.

It follows from this legal and regulatory position that any Master-KVG will, in the investment management agreement with the asset manager, try to protect its interests, both by imposing liability on the asset manager and by insisting on certain rights to give instructions to, and to audit, the asset manager (see below).

The same applies if the Master-KVG delegates or outsources only certain duties or other functions to another service provider, such as transition management. This also applies to mere sub-advisory agreements in which an investment manager is solely appointed as an adviser and does not take investment decisions on a discretionary basis for the fund (the KVG itself does). Please note that such sub-advisory agreements are nowadays rarely used and, therefore, will not be further discussed herein.

Special funds

When you receive a mandate from a German institutional investor to manage its money, a special fund will usually be established. This is the German equivalent to a Luxembourg SIF or an Irish QIF.

Under German law, special funds can be held exclusively by specific institutional investors. Such institutional investors are so-called professional and semi-professional investors.

Professional investors are professionals within the meaning of Annex II of the MiFID⁶ which are, in particular, credit institutions, investment firms, financial institutions, insurance companies, collective investment schemes, pension funds, large undertakings and certain other investors.

Semi-professional investors are investors who

- invest at least EUR10m into a particular fund; or
- invest at least EUR200,000 into a particular Fund, are evaluated as a suitable investors for the investment, and expressly declare their awareness regarding the risk of the proposed commitment or investment; or
- are certain managing employees or directors of an alternative investment fund manager (AIFM).

⁶ Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

Please note that the Master-KVG model also works with regard to **public mutual funds**. Public mutual funds are often established to sell a particular asset manager's expertise to private investors. However, some institutional investors also like to invest in public mutual funds and in some cases demand to be the single investor of such a public mutual fund.

There are two main differences between public mutual funds and special funds with regard to their reporting and publication requirements. First, a special fund (unlike a Luxembourg SIF) does not need to publish a prospectus; its fund rules only have to be submitted to – but do not need to be approved by – the BaFin⁷. Secondly, its net asset value does not need to be calculated and published on each stock-exchange day. Special funds are subject only to very few investment restrictions, notably that they cannot be established to pursue a 100% private equity investment strategy (only 20% of the fund's value may be invested in unlisted companies). However, certain investors, in particular insurance companies and pension funds, will be subject to additional investment restrictions⁸ that need to be reflected in the special fund rules or side letters.

Establishing a German special fund is simple: the KVG, the depositary and the investor(s) agree in a tripartite agreement that the investor will subscribe for units in the special fund, and that the fund will be governed by general and special fund rules, which set forth the investment restrictions. Often, investor-specific investment guidelines will contain further restrictions. By way of example, if the special fund rules permit the investment into derivatives for hedging and investment purposes, the investment guidelines may stipulate that derivatives may be purchased only for hedging purposes until further notice.

Regulatory requirements regarding the outsourcing of portfolio management

When a Master-KVG delegates essential functions such as portfolio management, the delegation must not adversely affect:

- the orderliness of such business or services;
- the Master-KVG's managers' abilities to manage and monitor them; or
- the BaFin's right to audit and ability to monitor them.

Thus, Master-KVGs must be able to give instructions to the asset manager whom they have entrusted with portfolio management.

Please note that nowadays not only the KVG but also the depositary of the respective fund must have contractually agreed audit and inspection rights, including unlimited access to the asset manager's premises and files. However, it is possible to carve out any information that relates specifically to other clients.

Master-KVGs occasionally want to delegate not only the portfolio management but also the pertinent internal audit functions to the asset manager. We normally advise our foreign asset manager clients in particular against accepting such function, as the asset manager would then have to structure and conduct its audits according to German rules and regulations.

The following rules apply whenever a Master-KVG wishes to delegate portfolio management functions:

- The Master-KVG is and has to be fully liable for the service provider vis-à-vis third parties and the investor.
- This means that a Master-KVG cannot limit its liability towards investors on the basis that it has delegated the portfolio management activities to the asset manager. Consequently, it will impose a strict liability on the asset

⁷ The German Federal Financial Supervisory Authority – “Bundesanstalt für Finanzdienstleistungsaufsicht” – **BaFin**.

⁸ For example, those mentioned in the German Investment Ordinance (*Anlageverordnung* – “AnlV”).

manager. Several attempts of asset managers to limit their liability to gross negligence or to foreseeable damages have been unsuccessful (see below).

- The delegation shall not in any way interfere with the effectiveness of the Master-KVG’s supervision; in particular, it shall neither interfere with the Master-KVG’s acting in the interests of its shareholders nor impair management of the investment funds which is in the interests of the shareholders.
- As a consequence of this rather vague rule, most Master-KVGs impose on asset managers an obligation to abide by the so-called “Rules of Conduct” issued by the German Investment and Asset Management Association (*Bundesverband Investment und Asset Management e.V. – BVI*). Under these rules, the execution of securities transactions is subject to clear principles, which ensure settlement in line with market conditions and equal treatment of all investors. The principles occasionally deviate from the rules, for example, in the UK, with respect to order aggregation, pre-allocation or cross-trades. Whilst the rules are not mandatory any more they are still adhered to by Master-KVGs. At least similar standards apply and the reconciliation of the Master-KVG’s internal and external policies and the asset manager’s internal and external policies can be very cumbersome; in general, the asset manager should be ready to provide the Master-KVG with the required level of comfort that it adheres to the applicable German provisions.
- The portfolio management may only be delegated to an asset manager that is licensed to conduct asset management and subject to effective supervision (exceptions apply with regard to the portfolio management in respect of real estate or real assets).
- FCA-regulated managers are acceptable to the BaFin, as are managers which are registered in the U.S. under the Investment Advisors Act. Other potential third-country asset managers must be subject to proper supervision and the cooperation of the BaFin with the home supervisory authority must be ensured.
- U.S. managers are allowed to manage German funds, even though they do not benefit from the “European passport” for cross-border investment services. While one could theoretically argue that a non-EU manager requires a German licence (which will only be granted following the establishment of a German branch office), the BaFin has repeatedly confirmed that no German licence or passport is required. The BaFin’s general right to audit and ability to monitor them must remain unaffected.
- The outsourcing shall not prevent the Master-KVG from giving further instructions to the asset manager, or from withdrawing such delegated responsibilities with immediate effect if such a step is considered necessary to preserve the interests of the investors.

As a result of this rule, the Investment Management Agreement and the Operating Memorandum or Service Level Agreement (see below) contain provisions pursuant to which the Master-KVG can, at any time, take over the management of the fund, if this is necessary to protect the interests of the investors. However, it is customary in these cases to exclude the liability of the asset manager.

Contractual documentation

Your typical documentation with a Master-KVG will comprise the following elements:

Investment Management Agreement (IMA)

The IMA (also outsourcing or portfolio management agreement) used by the Master-KVG will typically be based on the standard agreement established by the BVI, which covers in particular the regulatory requirements set out above, but obviously also liability issues. The IMA typically makes reference to the fund rules and the investment guidelines. It will also refer in an appendix to fees, which will typically be charged by the Master-KVG to the fund as an external expense.

While every Master-KVG uses the BVI standard IMA as a starting point for its documentation, each Master-KVG still has its own bespoke standard document, and there are significant differences between them (in particular in the operational part). During the course of the implementation of the AIFMD, IMAs were changed significantly to meet the requirements under the AIFMD and the German Investment Code (*Kapitalanlagegesetzbuch* – **KAGB**) implementing the AIFMD, respectively.

The Master-KVG's questionnaires

Most Master-KVGs require the asset manager to complete a detailed questionnaire in which it provides full disclosure on the systems it uses, its operational set-up, settlement details, etc. This questionnaire is used by the Master-KVG to determine whether a particular asset manager is suitable to manage a German fund and you might compare it to a due diligence exercise conducted by the Master-KVG on the asset manager. Furthermore, some Master-KVGs require the asset manager to complete additional questionnaires on an ongoing basis to comply with the Master-KVG's supervisory and controlling obligation. Historically, some questionnaires were also based on a BVI standard document.

The Operating Memorandum

The Operating Memorandum (**OM**) – often also referred to as the Service Level Agreement (**SLA**) – is of primary importance insofar as it regulates the day-to-day relationship between the Master-KVG, the asset manager and the depositary. It contains provisions on:

- trade and settlement instructions
- margin processing
- resolution of active and passive breaches of investment guidelines
- processing of corporate actions
- reporting (eg SAS reporting requirements (with amendments) which are increasingly becoming the market standard in Germany)
- trading in “new financial instruments”, handling of a “new product process”
- escalation procedures.

Some OMs not only cover operational issues, but also contain further provisions on liability, representations and warranties, etc.

As the OM forms an integral part of the Investment Management Agreement, its provisions should be approved by the asset manager's legal and compliance department.

The OM service levels and interfaces must also be clearly defined. Therefore, the BVI together with other market participants developed standardised business processes in portfolio management and fund unit trading (the BVI Securities and Transaction Standards). These standards take into account several business models used in Germany by brokers, advisers, depositaries and fund managers and standardise the contents and modalities of data communication, eg between asset managers, depositaries and Master-KVGs, and in particular for the use of SWIFT formats. Many KVGs agree upon these standards to make business processes easier, faster and more cost efficient, so any asset manager should also be aware of the content of these standards.

How to keep up to date – the A&O Updater

The BVI-standard IMA contains the following provision which will also be found in any Master-KVG IMA:

“The asset manager represents and warrants that (i) it possesses sufficient resources and a suitable organisational structure in order to properly carry out the outsourced activities, in particular that it employs sufficient employees with the required competencies, knowledge and abilities; (ii) it knows the legal provisions pursuant to (i) with respect to the

outsourced activities at the time of entering into this agreement, and it will continuously inform itself with respect to supplements and amendments to these provisions.”

In other words, a foreign asset manager represents and warrants that it complies with the applicable laws and regulations not only in the asset manager’s state of origin but also in Germany. This means that the asset manager must be familiar with German provisions such as the German Investment Code (**KAGB**), the ordinances and public statements of BaFin issued thereunder and the German Securities Trading Act (*Wertpapierhandelsgesetz* – “WpHG”).

Keeping up to date with the permanently changing regulatory environment is, particularly for foreign asset managers, sometimes very difficult. Therefore, Allen & Overy LLP offers you the **A&O Updater** – a service which keeps you informed on a regular basis about the most recent developments and changes with regard to the aforementioned laws and regulations, changing market standards and potentially interesting marketing opportunities.

Are you able to fulfil the following additional regulatory duties with regard to portfolio management?

KVGs, and also Master-KVGs therefore, are subject to stringent operational requirements and rules of conduct, especially following the implementation of the UCITS IV Directive and with UCITS V to be implemented by the EU member states and UCITS VI on the horizon. In particular, the following provisions specify the duties with which a Master-KVG has to comply. These obligations are partly passed on to the asset manager.

- Ordinance to specify the Duties on Conduct and Organisation according to the German Investment Code (*Kapitalanlage-Verhaltens- und -Organisationsverordnung* – **KAVerOV**).
- BaFin’s Circular Minimum Requirements for the Compliance Function and Additional Requirements Governing Rules of Conduct, Organisation and Transparency pursuant to Sections 31 *et seq.* of the Securities Trading Act for Investment Services Enterprises (*Mindestanforderungen an die Compliance-Funktion und die weiteren Verhaltens-, Organisations- und Transparenzpflichten nach §§ 31 ff. WpHG für Wertpapierdienstleistungsunternehmen* – **MaComp**).
- BaFin’s Circular Minimum Requirements for Risk Management for KVGs (*Mindestanforderungen an das Risikomanagement für Investmentgesellschaften* – **InvMaRisk**).

All these duties also have relevance for, or can even be performed only by, the asset manager. Therefore, the Master-KVG will contractually oblige the asset manager to fulfil them.

The asset manager will be obliged to comply with the applicable laws and other regulatory requirements while performing its portfolio management services. This increases the asset manager’s duties with respect to its organisational structures as well. Such duties could comprise, *inter alia*:

- the establishment of cash and liquidity management systems (eg with regard to the overall liquidity of the relevant fund);
- the set-up of internal risk control procedures and a compliance function;
- the establishment of employee trading guidelines and documentation of personal transactions;
- the establishment, observation and maintenance of a conflicts of interests policy;
- the performance of a pre-investment due diligence before investing into assets for the fund;
- the establishment of a best execution policy;
- the duty generally to not accept inducements or, if it increases the quality of the service, to at least fully disclose them (not necessarily required with regard to special funds); and
- the recording and reporting of all portfolio transactions entered into for the respective fund.

The BVI standard agreement reflects these duties. In case of a sub-delegation equivalent duties will have to be imposed on the sub-delegate as well. Please note that the Master-KVG must notify BaFin about the outsourcing to the asset manager under the IMA before the IMA comes into effect; a consent by BaFin is, however, not required.

Liability

As already pointed out, liability is always a contentious point and every Master-KVG takes its own approach in its documentation. Although the Master-KVG will be liable from a legal perspective towards third parties and the investor(s) with regard to delegated or outsourced services or functions, it can take recourse against the asset manager if the asset manager's investment decision breaches investment limitations and the respective fund suffers damages. Most KVGs refuse to limit the liability of the asset manager to direct and foreseeable damages and, with regard to the asset manager's liability, the principle of contributory negligence often does not really work and it is difficult to assess to what, if any, degree the parties are responsible for damage caused.

With regard to the liability for brokers, the KVG is in general only liable if the KVG has (a) not selected the broker properly, (b) not monitored the broker's performance properly, or (c) failed to instruct the broker properly; this means that the KVG will not, for example, be liable in the event the broker defaults on its payment or delivery obligation. However, we are not aware of any judgments in which a KVG was held liable with regard to a broker default. Consequently, the asset manager should, in the IMA, also disavow or reject any liability for broker default.

Despite the fact that the Master-KVG is not, as noted above (and under normal circumstances) liable for any action carried out by the broker, some Master-KVGs require the asset manager to take full liability for any such broker instructed by the asset manager. However, this potential liability could be mitigated by, *inter alia*, (a) liability in the event the asset manager does not instruct the broker properly, (b) an exclusion of liability in the event of a default caused by an insolvency of the broker, and (c) a complete exclusion of liability if the asset manager has to instruct brokers according to a predefined list of brokers the Master-KVG works with.

Acting in the name of the Master-KVG or acting in one's own name

Under the IMA with the Master-KVG, the asset manager takes the investment decisions on a discretionary basis and places the trades via a broker. But in whose name are the trades for the respective fund executed? This could be executed on the one hand in the name of the asset manager itself and on the other hand in the name of the Master-KVG. Since the fund usually does not have a legal personality (see above) it is obvious that the asset manager clearly cannot act in the name of the fund. Notwithstanding the foregoing, the asset manager must in any case be granted the required power of attorney and finally a trade must be carried out for the account of the fund. In other countries, such as the UK, sometimes a combined version of both applies where the asset manager acts "as agent for an undisclosed principal".

In many cases the asset manager does not properly disclose in whose name it is acting to the broker. Such disclosure is required, however, if the asset manager wants to act in the name of the Master-KVG. The name of the Master-KVG must be disclosed to the broker in advance; the broker then bears the counterparty risk of the Master-KVG. If the asset manager wants to enter into an OTC derivative transaction for the account of the fund under German law, it must act in the name of the Master-KVG and does not have the option to act in its own name. In these circumstances, it must also be ensured that the relevant Master-KVG enters into the necessary OTC framework and master agreements (depending on the type of derivative transaction).

Risk management and market risk

Nearly any investment strategy can be wrapped in a fund nowadays under the KAGB by investing into eligible assets such as derivatives. While investing into such assets, eg credit derivatives or total return swaps, the portfolio of a fund

can be leveraged up to 100%. In the latter case, however, the market risk of the fund is doubled which also causes a higher risk overall.

Accordingly, appropriate risk management systems and procedures must be implemented by the respective Master-KVG to monitor such risks sufficiently. In accordance with the ordinance on derivative financial instruments (*Derivateverordnung – DerivateV*) the Master-KVG may take two different approaches. If only less complex “plain vanilla” derivatives are purchased for the fund, the Master-KVG may follow the so-called “simplified” risk management approach (*einfacher Ansatz*). In the case of rather more complex products, such as speculative credit derivatives or total return swaps, the “qualified” risk management approach (*qualifizierter Ansatz*) must be implemented to calculate the market risk. In any case, the Master-KVG must be able to adequately capture the risks of any such securities with its risk management system. Therefore, if the portfolio management is outsourced to an asset manager, the asset manager must assist the Master-KVG in such risk management activities and analyse derivatives for the fund, establish or help to establish model or reference portfolios and provide information for the pricing of the respective instrument (or sometimes even guarantee the pricing, eg if the asset manager has very particular know how with regard to the respective assets).

White label funds and exit scenarios from the asset manager’s perspective

As set out above, many institutional investors set up “their” own fund with a Master-KVG to be able to appoint different asset managers for their fund or segments of their fund. However, Master-KVGs also offer their services to asset managers. An asset manager may “order” a fund with the Master-KVG which sets up the fund and appoints the asset manager of the fund so that the asset manager is able to implement his expertise and investment strategy in “his” fund. The asset manager is then able to promote “his” fund and search for investors (private and/or institutional investors). The same applies if the asset manager receives a big mandate from an institutional investor and establishes a fund via a Master-KVG.

In each case the asset manager can consider the fund as “his” own fund although from a legal perspective the fund as such is managed by the Master-KVG and the Master-KVG continues to be the entity ultimately responsible for the fund. Legally the asset manager as a service provider is linked to the Master-KVG and the fund only by the IMA.

Therefore, a Master-KVG could theoretically terminate the IMA with the asset manager and replace him with another asset manager so that the former asset manager loses “his” fund. Although this is, from the Master-KVG’s reputational perspective, very unlikely as an institutional investor would most likely withdraw its investments if the Master-KVG appoints an unwanted asset manager, one should implement according provisions in the IMA on how to deal with this situation so that if the IMA is terminated the Master-KVG will, at the instruction of the asset manager, terminate its mandate for the fund and transfer the fund to another Master-KVG in accordance with the time limits and requirements under the KAGB. This refers to public mutual funds as well as to special funds. In the case of a public mutual fund, however, such provision could be agreed upon in a side letter to the regular standard fund documentation and it would be a sensible precaution to do so.

VAT on portfolio management services?

There have been discussions in the past as to whether and to what extent any investment management services outsourced or delegated to an asset manager are subject to value added tax (VAT). However, under the applicable laws and following the decisions by the European Court of Justice, the German tax authorities take the view that portfolio management services are not subject to VAT. For other outsourced and delegated services, one has to look at each individual case.

Please contact us:

For additional advice and information please rely on the Allen & Overy Regulatory, Funds & Financial Products Group.

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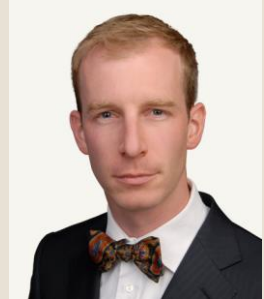


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