Funds@Work®

October 2005

Fund investments
by German institutional investors –
highlighting the legal framework for insurance companies

NORTON ROSE

Dear Reader

With this issue as the first of a new series of briefings Funds@Work would like to present an overview on current market developments which we have dealt with extensively in our international projects. In our opinion a more common understanding of the addressed topics will help the market grow. Future topics will not be limited to the German market only.

The topic of mutual funds for institutions has been around for several years now and Funds@Work was among the first to implement such strategies successfully together with its clients. We have been a pioneer in communicating this topic again and again to build up a common understanding among investors, asset managers and service providers. It is still a big topic though and needs a critical review regarding the most recent developments. We have therefore extended our view to what we term as "multi-owner vehicles", because not all solutions that can be applied to current needs of the investors can be solved with mutual funds.

Funds@Work takes care of the entire value chain of asset management as a strategy consultant with own research capacities. As part of our modular business model we do work with experts in order to manage the complexity much better. With regard to legal advice we rely on Norton Rose. Their contribution to this briefing is very important since they focus on regulatory issues based on the example of insurances investing into mutual funds.

Insurances manage half of all institutional assets in Germany under a tight regulation which has been subject to change over the past 12 months. Since legal issues play an important role in facing strategic decisions, it is worthwhile combining the skills of a strategy consultant with an expert's view from Norton Rose, Frank Herring.

Now, enjoy your reading!

Jan Altmann
Funds@Work AG

Content

Fund investments by German institutional investors

Fund investments by German institutional investors - highlighting the the legal framework for insurance companies

Background

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Fund investments by German institutional investors

Institutional investors today have more options than five years ago, not only with regard to potential instruments but also with regard to external service providers who can help them restructure their assets. The increasing modularisation within the asset management industry has led to new players offering their services and led to external experts increasingly performing the traditional functions which had been an integral part of institutional investor's and asset managers´ organizations. Foreign players are experiencing increasing success in this arena.

Through the increased variety of players in the industry and the legal frameworks in which they operate, institutional investors in Germany have, among other things, discovered what we term as "multi-owner vehicles". These kinds of investment structures can be categorised as investment vehicles owned by multiple institutions and/or entities open to a wide variety of investor groups. These can be mutual funds such as those offered to the public through the known distribution channels, exchange traded funds ("Exchange Traded Funds" or "ETFs"), fund of funds or even multi-manager funds. Some providers have launched mutual funds customized for institutions with appropriate minimum investments and cost structures as with institutional share classes (institutional shares).

In this briefing we would like to take a detailed look at the phenomenon of "multi-owner vehicles" and later hand over to Norton Rose to describe the legal framework that governs insurance investments in Germany. In particular, we will look at the major drivers and describe how they might influence investors in order to give asset managers and investors alike some valuable recommendations.

1 Major drivers for new institutional portfolio structures

1.1 Conversion of accounting standards to IAS/IFRS

1.1.1 The impact on asset managers and their clients

According to the EU guidelines on accounting and their amendments from July 2002 and beyond a growing number of companies are required to present their balance sheets according to the International Accounting Standards - IAS, now complemented by the International Financial Reporting Standards - IFRS. This switch to new accounting standards has massive implications on the structure of the assets of a company or institution which is often pooled in proprietary funds, so called "Spezialfonds". Usually investors own 100 percent of these vehicles and will have to consolidate the assets as a special-purpose vehicle under IAS 27, SEC12 in their consolidated balance sheet. The required consolidation method does not differ too much from consolidating a complete company into the balance sheet: All inflows and outflows have to be reported as well as all capital gains and losses - for the investment funds in total and also for each underlying of the fund. The reporting systems of the asset management providers, administrators such as the German Master-KAG, custodians and the corporates themselves were not ready yet for the new international accounting standards. If the institutions have only limited influence on the assets (which is usually the case when the ownership is less than 20 percent of such assets) they do not have to report them in detail - the assets then appear only as a single line on the balance sheet usually at their net asset value.

1.1.2 The treatment of publicly registered funds under IFRS/IAS

Following the current discussions there seems to be a consensus among accountants that assets with limited ownership in funds (lower than 20 percent) will not need to be fully consolidated under IAS27 and SEC12. Publicly registered funds being used by institutions fulfil these criteria. Large funds are held by many different investors so institutions do not have to fear in hitting any critical limit of ownership with regard to IAS/IFRS. Exposure to smaller funds can be obtained by investing into smaller positions as in the case of certain satellite-investments. Alternatives like multi-owner-Spezialfonds, institutional share-classes or other opportunities are discussed later in the solutions chapter.

1.1.3 First wave in 2005

In 2005, all companies listed on a European stock exchange had to migrate to IFRS/IAS. Most of them had already switched

over earlier because the standards require a previous year's figures with which to compare those of 2005. Companies had to collect data from the beginning of 2004.
Experience shows that many organizations are late in making the conversion which might be one reason why the trend has reached the asset managers later than expected.

Companies which have switched which have affected the asset management industry include

- Insurance companies listed on a stock exchange
- Banks listed on a stock exchange
- Other corporates of any kind listed on a stock exchange

Due to bank and insurance domination in Spezialfonds investments, a large part of institutional portfolios have been affected. The bigger players in Germany for example hold more than 400 bn. EUR of the total volume of institutional Spezialfonds assets according to the German Association of Investment Funds, BVI.

1.1.4 Second wave in 2007 to follow

In 2007 we will see the first reports from many other companies which have been active in capital markets as issuers of bonds. But more or less every company which has issued a bond can be subject for the conversion to IFRS/IAS. This includes market participants like:

- Cooperative banks
- Savings banks
- Mutual insurance companies
- Corporates without exchange listing
  but with pension liabilities

Most of these players are mid-size banks, insurance companies and companies where the economies of scale for large Spezialfonds are not existent. Savings banks manage about 330 bn. EUR in their Depot-A (on their own account), cooperative banks about 60 bn. EUR. Not all of them are due to switch to international accounting standards it might apply to the larger one at least.

1.1.5 Implications on HGB accounting

For some investors like foundations, the churches or public institutions the IAS/IFRS rules might not be relevant at all. Others like family owned companies will stick to the national accounting standards of HGB (Handelsgesetzbuch).
For most accountants, however, it is likely that the legislator will change the current interpretation of the HGB standards to IAS/IFRS congruent rules. In the mid-term, entities with HGB accounting might also have to adopt the standards. The only exceptions which will remain will be foundations and clerical institutions without for-profit character and - interestingly enough -public institutions.

1.2 Increasing modularisation of the industry

There have been considerable changes over the last three years in the German market and the increasing modularisation has led to the emergence of new players that offer their services to local as well as international asset managers and investors alike. Boutiques or universal players have gained considerable ground. In this increasingly modular environment new and existing concepts have surfaced and gained in importance in Germany such as the Master-KAG, Multi Managers, Investment Consultants, Fund distributors, the importance of standards and alternative forms of cooperation, transition and overlay management services, best execution and many more.

1.2.1 Smaller asset managers and boutiques

Growing modularisation has also increased opportunities for specialised asset managers. The changing industry structure leading to lower entry barriers has given them the opportunity to compete with established players in a rather open architecture. The phenomenon includes both domestic and foreign boutiques as well as independent asset managers who initially started off as boutiques and have now become universal players.
Significant assets were transferred to the more successful boutique managers, mainly from the retail and wholesale investors. The institutional players were a bit slow in following because of concerns about the sometimes small fund volumes and potential consequences in choosing rather unknown asset managers. The legal wrappers used by boutiques are generally publicly registered funds. Most of them do not have the KAG-infrastruc-

ture or the distribution network to offer and manage mandates. Some examples for successful German boutiques are:

- Wolfgang Mayr, 300 Mn. EUR AUM, global equity quant portfolio
- Lupus Alpha, 4.0 bn. EUR AUM, equity market neutral and small cap portfolios
- Dr. Jens Ehrhardt, 2.7 bn. EUR AUM, Active equity strategies etc.
- First Private, 1.4 bn. EUR AUM, European equity quant portfolio

Altogether these boutiques have, relative to the BVI-members, grown exceptionally in the past two years coming from a low level of AUM.

1.2.2 Master-KAGs

The Master-KAG represents a fund administration platform, being responsible, among other things, for fund accounting and administrative functions not linked with the portfolio management. Large institutional investors use Master KAGs to concentrate their assets in a few vehicles all under administration of the Master KAG. The Master KAG is, among other things, responsible for reporting and administrative activities as well as managing the interfaces of relevant parties involved while the assets are managed by external asset managers. In Germany Master-KAGs enable asset managers, whether local or foreign, to manage portfolios without having to establish their own German investment management company. Many investment boutiques have launched their funds either through a Master KAG as a publicly registered fund or have used a similar structure in Luxemburg or Ireland where such outsourcing of administrative functions has a longer tradition.

1.2.3 Exchange traded funds as new passive component

Launched five years ago Exchange Traded Funds have attracted 30 bn. EUR of assets in Europe within the past five years. ETFs are mentioned here although they are meant to be a short-term investment tool. But so far no provider of passive retail products could evolve in Europe like Vanguard which now is the largest fund provider in the US, way ahead of active managers such as American Funds (Capital Group) or Fidelity.

More than 140 ETFs are available in Europe. Institutions, though, will only go with the larger ones to limit the risk of hitting ownership limits. Except for a few funds all ETFs are UCITS compliant and can be used even by target groups such as insurance companies.

1.3 Core-satellite strategies

The success of the core-satellite approach is of course based on the savings that can be made on management fees and the growing awareness that many active managers do not beat their relevant benchmarks in 70-80% of the time depending on the time horizon looked at it can even go to more than 90%, this especially applies to liquid markets. In fact, we can distinguish a core made up of passive or enhanced management vehicles like index funds, passive mandates or the already mentioned ETFs with low management fees, from a selection of very active satellites, or even funds with no constraint on managing relative risk with regard to a benchmark.
Secondly in Germany the right time has come to implement such approaches because of all the emerging investment boutiques and foreign players as candidates for satellites and the providers for passive asset management coming more into play.

1.3.1 New opportunities for core components

German investors have always been very reluctant to passive investing. Possible reasons can be the lack of alternatives in an historically rather "closed shop", strong sales and marketing efforts of the active managers, a lack of specific sophistication among investors or a general lack of standardisation in the industry. According to estimates by investment consultants and research agencies, the portion of passive components in German institutional portfolios is only up to 10 percent compared to 25 percent in Switzerland, 30 percent in the UK or 35 percent in the US. While one of the largest passive managers, State Street, has recently closed its KAG-business in Germany making use of the new opportunities as an advisor, the world's largest provider of passive asset management, Barclays Global Investors, has never opened up domestic operations in Germany.
Maybe there is reason for change in the German market. Multi-owner vehicles like ETFs or mutual index funds could play a leading role here. The offering of index products has increased

significantly: In the past three years about one hundred new indices or index families available to European investors have been launched. The index providers have been innovative and offer investors new types of asset classes or investment structures. Consequently the providers have started several new instruments and have taken the efficiency regarding liquidity and tracking on to more quality.

In the recent two years passive products appeared on the scene that can even be included as a satellite like ETFs trackin more or less uncorrelated markets - like China, Iceland, Turkey or Eastern Europe for regional purposes. ETF tracking markets like commodities are also available.

1.3.2 Satellite handling

A consequent core-satellite which is more than feasible with multi-owner vehicles of course needs a flexible and wise handling of the satellites. Meanwhile enough alpha-generators are available as publicly registered funds. The current short-term orientation of German investors should be conducted with satellites rather than controlling all asset managers for the strategic core in this term. Generally, in order to manage the surrounding alpha-elements successfully, more resources will be required than for a long-term strategic asset allocation with mandates. But the increased use of investment consulting services certainly enables German investors to monitor more of the ongoing activities and short-term opportunities on the capital markets. Investment consultants are estimated to be consulting 20-25 percent of German institutional assets, a number that is higher if insurance companies and banks are excluded, which have traditionally built up in-house capabilities. The following consultants, amongst others, are currently active in asset structuring:

Company	Principal office
alpha portfolio advisors	Bad Soden/Ts.
AMC-Brauel	Friedrichsdorf
Aon Jauch & Hübner Consulting	Mühlheim/Ruhr
Bfinance	München
Delfi Concept	Ludwigshafen
Dr. Dr. Heissmann	Wiesbaden
Eller Consulting & Training	Meitingen
Faros Consulting	Frankfurt
Feri Institutional Management	Bad Homburg
FondsConsult Asset Management	München
GSC-PPCmetrics Investment Consulting	Wiesbaden
Hewitt Associates	München
Mercer Investment Consulting	Frankfurt
Protinus	München
Rauser AG / Towers Perrin	Reutlingen
RMC Risk-Management-Consulting	Köln
Südprojekt Finanzanalysen	München
Towers Perrin	Frankfurt
Watson Wyatt	Düsseldorf

1.4 Other drivers

1.4.1 General need to consolidate existing Spezialfonds structures (risk management)

Many German investors have divided their assets into various Spezialfonds. Some of the mid-size investors operate up to 40 different Spezialfonds. However, it is difficult to administer such a high number of Spezialfonds. It is nearly impossible to conduct consolidated risk management as required by the regulator e.g. for insurance companies in such a structure. Many investors have already restructured their assets in the past two years to a smaller number of Spezialfonds administered by Master-KAGs. This is particularly true for larger investors. Master KAGs had massive inflows and have now more than 200 bn. EUR of assets under administration. Once restructured, it will be difficult to transfer the assets at the Master KAG to multi-owner vehicles. However, we will see later that it is now possible for Spezialfonds to buy traditional mutual funds.

1.4.2 The need to increase regional diversification

Savings banks and cooperative banks as well as public entities or foundations are still often dominant in domestic securities like government bonds or equity. The lack of German economic growth has shown an emergence to diversify the portfolio regarding regional focus and asset classes. Core-satellite approaches or the process of modularisation provide efficient solutions for such a need.

1.4.3 Institutional share classes

Together with the new investment act institutional share classes have been made feasible for German funds too. But yet, one year later, no fund has been registered with share classes by the legal authority, the BaFin. Other UCITS-funds e.g. from Luxemburg or Ireland have been registered in Germany already earlier. In general, institutional share classes can make mutual funds more attractive for institutions in terms of cost or also dividend payments.

2 How to approach investors with solutions

One solution for these emerging drivers of investor's needs are "multi-owner vehicles". These vehicles do not differ greatly from existing open ended funds for retail investors or are sometimes similar - but with different cost structures. It is important to offer the right vehicle for the relevant need. This often requires a change from the product driven approach to a solution driven strategy - even though the funds might be used in a product driven strategy towards retailers.

In order to provide institutional investors with the right solution the unique needs of the individual investor groups must be taken into consideration. To find the right fit between the core competence of the provider and the specific needs of the investors regarding a solutions portfolio requires a strategic approach where not only the strengths and weaknesses of the asset manager play a role. Also market intelligence on where the industry is heading has to taken into account and, above all, investor insights based on a detailed analysis of their needs. Apart from screening the market environment in a structured and highly sophisticated model-based way in order to determine investor needs, we generally carry out an external analysis for our clients to talk to the relevant target groups and get their view with regard to their needs and their attitudes to certain solutions offered. The design process is turned around essentially, meaning it starts at the customer and results in an appropriate solution.

In this more general briefing we would like to outline the opportunities and obstacles (or challenges) for providing investors with multi-owner solutions - focussing on both sides.

2.5 Strengths of multi-owner vehicles

2.5.1 Flexibility

In interviews we conducted on behalf of our clients, the majority of investors commented on how flexible publicly registered funds are. Units of publicly registered funds are easy to create or to redeem. Multi-owner vehicles can substitute existing or planned Spezialfonds-mandates, usually in sizes between 10 to 50 mn. EUR. Daily pricing at least for the open ended vehicles is common.

Many of the investors also commented in interviews that custody for fund units is not a challenge. Even if the custodian does not support this feature there are enough professional fund platforms that also support the needs of larger investors. The use of Exchange Traded Funds is even less complicated. Buying and selling can happen in seconds instead of daily pricing. The process for trading ETFs is more or less the same as for trading stocks: The investor gives his order to the broker and the broker executes it via the central order book on the exchange. As is the case for shares, ETFs are cleared in T+2 or T+3. If ETFs are traded on Xetra, the by far most liquid platform for ETF-trading in Europe, clearing and settlement goes through Clearstream in an STP-process. Investors simply have to take care of the current price depending on spreads and the fit with the continuously calculated NAV - also there is no difference to direct investments into other securities. A direct contact to one of the market participants active in ETF trading can lower the spread for larger blocks in off-exchange trading.

Multi-owner vehicles are also flexible enough to succeed in various existing structures of assets: Investors can substitute their complete portfolio, buy them into Spezialfonds structures or simply use them as satellites.

How investors implement one of the following concepts depends very much on their own current situation:

- Individual investment goal
- Size of the portfolio to be transferred into multi-owner vehicles
- Constraints on the transfer of a portfolio (hidden assets)

2.5.2 Opportunities to include multi-owner structures

Complete portfolio. For small to medium sized institutional investors it is generally possible to build a complete portfolio out of multi-owner funds around the investment goal of the investor. If a core-satellite approach is used, passive products like bond-ETFs, equity and real estate could build the core. Active boutiques will represent the satellites. These asset classes are widely available as publicly registered funds. The tactical asset allocation can work through the use of alternative investment funds or through creating and redeeming the core elements which is feasible due to their flexibility. A derivatives overlay might not be suitable when using active mutual funds due to a lack of insight into the current portfolios. If applied to a passive structure with a high grade of transparency, as is the case for ETFs, a derivatives overlay can add value for short term market movements. This solution would work for smaller institutions like smaller insurance companies, pension trusts or foundations.

Another advantage is the scalability of the solution: If the investor gets big inflows, as is to be expected for pension funds in Germany, the structure can be transferred to a Master-KAG-structure with Spezialfonds without replacing the managers.

A separate overlay could be employed to create additional alpha if the portfolio does not have a core-satellite structure. Such an overlay management can be implemented if the portfolio components are transparent enough. This would be the case for Exchange Traded Funds or passive products. On the other hand, an overlay would not be necessary on a tactical asset allocation because the multi-owner funds are flexible enough to change the allocation quickly.

Spezialfonds Masterfund. It is possible to buy mutual funds into Spezialfonds since Spezialfonds have been included in the regulation under the new investment act. The limits for investments into multi-owner vehicles do not differ from the restrictions applied to mutual fund managers. It is even possible to launch Spezialfonds in a Fund-of-Fund construction type. However, the exact limits for the participation in mutual funds still depend on an official paper from the regulator "BaFin" which is still pending. The exposure to ETFs would enable Spezialfonds-managers the following features:

- Immediate diversified exposure with market risk to certain investment categories where no specific research for active decisions is available.
- Adjustment of short-term inflows or liabilities with diversified vehicles
- Application of short strategies when the use of derivatives like index futures is not applicable
- The application of these features of course depends on the regulation of the individual institutional investor.

Multi-manager Funds. This type of fund is still quite new on the German market and has not attracted much investor interest yet. Managers are selected in a professional manner on to a managed account platform to manage slices of a multi-owner-structure like a publicly registered fund. Several providers have recently announced that they will launch multi-manager funds for institutions. The funds are sometimes advised by investment consultants who want to leverage their expertise in manager selection but generally by specialised multi managers.
Of course the allocation cannot be tailor-made for the investor but in most cases the providers have launched a series of portfolios with different risk profiles. Many multi-manager products to be offered to the wider public haven not attracted enough investor interest and have generally not acquired the necessary seed money yet. In the table below are the current providers and advisors in the German market:

For investors such a vehicle might not be optimal because it can not be tailored to the specific needs of certain investor groups. A solution to this problem could be institutional share classes for specific investors.

Manager selectors	Product sponsors
Feri Institutional	Multi-Manager Fonds Consulting MMFC
Frank Russell	Metzler Asset Management
Innovest Finanzdienstleistungs AG (Vienna)	Siemens Financial Services
Mercer Investment Consultants	Mercer (announced)
Northern Trust Global Investment	Heleba
RMC	Deutsche Asset Management DeAM
SEI	Commerzbank

Direct holdings plus satellite funds. Many investors, like insurance companies, prefer a mix of direct holdings and Spezialfonds. Multi-owner vehicles might usually be too small to replace any of the core investments of larger investors. But investors could use them to produce alpha in a satellite manner. Some asset managers offer low correlated equity exposure which can be used alongside an equity core. Other asset managers offer access to high-yield bonds or preferred securities (e.g. Spectrum, a subsidiary of Principal Global Investors) and other sub-segments within the bond asset class in addition to existing direct bond investments. The use of an external investment consultant can be an alternative for the manager selection as described in later.

Institutional fund of funds (long-only). This investment format is often used for retail investors or affluent clients of private banks to further diversify risk. Institutions can profit from a very high grade of diversification and do not need any competence for fund research. But these funds also have disadvantages: The same process could be reached with a fund portfolio in a managed account combined with the use of external fund research or investment consulting at a lower cost. Additionally, the fund selection is limited to funds which are registered for public distribution in Germany, whereas most institutions do not benefit from such a narrow focus.

Regulatory aspects. When investors place their money into the hands of others, registering the product with a UCITS will help to reduce issuer risks, as is the case with mutual funds. UCITS funds bear no liability should the product sponsor become insolvent, in comparison to private equity companies or the like. From a taxation point of view there is no advantage for institutions. Investors or managers who represent large family assets can benefit from this advantage when a succession within the family is expected in the mid-term.

2.6 Weaknesses and challenges for multi-owner solutions

2.6.1 Fund selection

On the one hand, many investors see the high number of available publicly registered funds as an advantage compared to the limited number of active institutional players in the local market. But on the other hand, due to the high number of available mutual funds in Europe and other factors the selection process appears to be a challenge.

Some investors or their investment consultants tend to use domestic data sources for retail products. Data quality is usually low: Most of the data sources deliver different performance figures for identical share classes and terms - even for very common funds. In addition, institutional share classes are usually not accessible or the information about the fungibility of the share class for certain investor groups is not available. Conditions and fees cannot be compared in the existing portals, transaction cost is not monitored and retrocessions are not included.
Furthermore, institutions often do not need a registration for public distribution in Germany. As there is no tax advantage a UCITS-registration in one European country will be sufficient. Retail portals and rankings only include domestically registered mutual funds and are therefore not sufficient for a professional selection process.

Some professional investment consultants use their existing manager expertise for mandates and transfer it to the world of publicly registered funds. Managers without a track record in institutional business and no presence in the databases of the consultants will therefore only have a very limited chance to get on the shortlist for a professional allocation.

One of the requirements to enter the databases of the investment consultants is GIPS, the Global presentations standards. Many mutual fund providers with potentially good products for institutions are not used to such a level of professionalism in reporting.

2.6.2 Customer relationship management

To address investors with the right fit of multi-owner vehicles a solution driven customer approach is a prerequisite. In order to enhance the efficiency of customer relationship management, providers should have the following infrastructure and processes in place:

- Experienced staff with expertise in all kinds of investment structures like Spezialfonds as well as mutual funds
- Thorough preparation of acquisition activities with all available data on the investor
- Collection of all relevant knowledge and documentation in a company-wide available investor database
- Detailed market intelligence monitoring the relevant target groups and their changing environment as well as needs
- An established system for feedback from sales to product development
- Strategic alliances with relevant market participants to get deeper insights

A product push approach will not open the doors to the institutional investors. They are already overloaded with daily enquiries from asset managers. If the asset manager has no inhouse competence for institutional CRM an independent third party might be of help to build up this crucial capability.

2.6.3 Size

Investments into mutual funds by institutions are of course limited by size when investors would like to benefit from the advantages concerning IFRS accounting. This is also the case for ETFs.

Just an example: A 3 bn. EUR portfolio (mid-size pension trust) mainly consists of bonds and on average a 7% equity component. The bonds can be diversified over e.g. 3-7 different ETFs depending on the regional focus, maturity and asset class. This still implies an investment of up to 700 m. EUR into one single ETF which might be too much to stay below the investment limit of a maximum of 20 percent ownership in order to benefit regarding IFRS/IAS. Other mutual index vehicles should be considered to build the core or a combination of Spezialfonds and mutual funds.
On the other hand, funds could be used to add interesting (highly uncorrelated) alpha-satellites like active boutiques which are also much too small to be used as core components. Another option is to use ETFs on uncorrelated markets like Turkey, Iceland or China.

2.6.4 Costs

One important disadvantage in the opinion of many investors we have been speaking to were costs. Institutional investors who are used to investing in larger blocks complained about taking care of the costly handling of smaller retail orders. These costs are usually not billed with the management fee but do cost performance. Mutual funds are significantly more expensive than mandates at a first glance. Using European blue-chip equities as an example: The average management fee for mandates according to recent studies by Greenwich and Dr. Dr. Heissmann is about 33 basis points. A comparable mutual fund is usually not available under 60-70 basis points including retrocessions or institutional share classes. But the management fee of mutual funds already comprises all the brokerage costs while investors often pay this separately for managed mandates. The fund providers often argue that they have additional costs for the legal setup as publicly registered fund.

If the costs cannot be cut down with institutional share classes there is still a possibility for retrocession fees. The ideal format would be a retrocession fee which could be compensated against a variable outperformance fee. The retrocession fees however would require additional administration for the fund company and above all a fair and transparent process to calculate the relevant flows. However, with retrocession fees multi-owner vehicles will remain more expensive which is the price that has to be paid for features like enhanced flexibility to exit at any time. This intrinsic value is usually not considered in these calculations.

The same can more or less be said for ETFs: ETFs range between annual fees of 9 to 55 basis points which is significantly more expensive than passive mandates. Investments into ETFs require an annual management fee and a very low spread of 8 to 20 basis points for blue chip products for buying and selling on an exchange - but only once for a whole diversified portfolio. On the other hand, ETF investors generally do not have to pay any additional costs with managed mandates such as transactions, transfers, reports and custody costs. Additionally, investors must consider opportunity costs for the inflexibility of a managed mandate. A net view shows that ETFs are not significantly more expensive than traditional managed mandates if all costs are considered.

2.6.5 Payout terms and dividends

Due to the higher grade of standardisation, mutual funds may not satisfy the needs of institutional investors particularly regarding **payout terms.** Many insurance companies would like to influence the payout before the year ends in order to manage the impact on the balance sheet, while many foundations would like to get more frequent payouts (e.g. every quarter) in foreseeable size.

2.6.6 Reporting

Another important point is **reporting**. Institutions generally have different reporting requirements than those of fund companies for their retail clients. This can be seen in the case of insurance companies as later shown by Norton Rose.
Most of the mutual funds provide monthly reporting of performance and the 10 largest holdings. Some fund providers have started to integrate institutional fund business and retail business. Apart from other advantages a reporting in professional quality is often available because fund providers have started to also integrate their back office systems.
The main requirements from the investor's side are:

- Insurance companies often like to see a full portfolio composition for purposes of clarity
- Many investors under the Solvency II regulations require data for risk management like daily portfolios, volatility (of the underlyings) etc.
- Nearly all investors need data on performance attribution compared to individually agreed benchmarks

3 Final remarks

The use of multi-owner vehicles in a broader sense or publicly registered funds for institutions will have a massive impact on the market. As mentioned above, current surveys have indicated that investors have already taken notice of this development and plan to shift assets into these multi-owner categories. There is no doubt that Spezialfonds will continue to exist and provide certain large investors with advantages. But the increasingly modular investment industry has the opportunity now to create many new relationships and solutions providing focused on customer needs as part of a holistic strategy.

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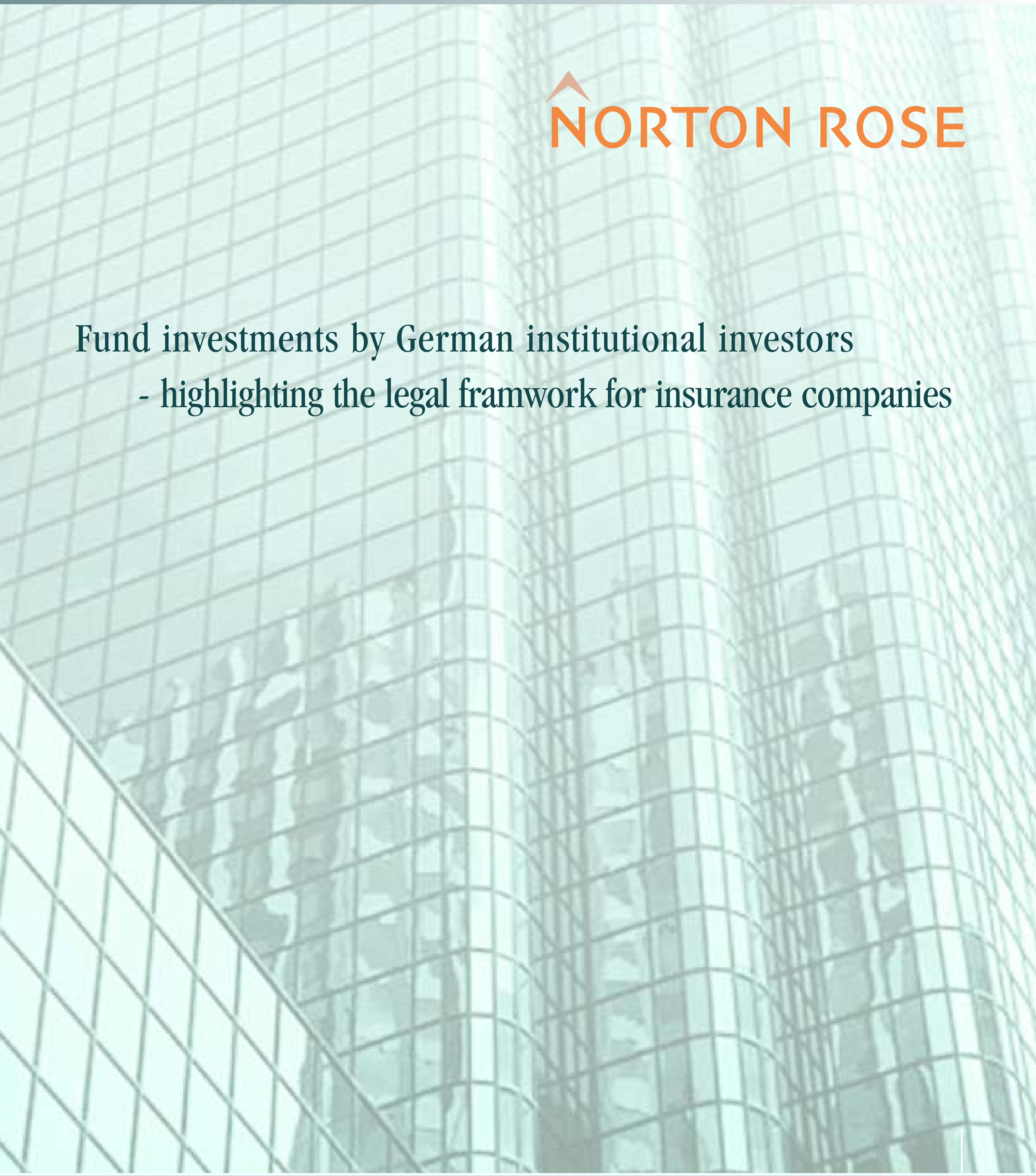


Fund investments by German institutional investors
- highlighting the legal framwork for insurance companies

This briefing shall help product developers, in-house legal experts and tax advisors to find their way through the maze of German insurance regulation and taxation of fund investments.
German insurance companies and pension funds are the most important class of institutional investors in Germany. Each day, they have to invest more than 1 billion Euros. Investment funds - both special funds but more and more also mutual funds - are an attractive investment for German insurance companies; non-German investment funds from specialist managers are currently much in demand.
The German rules relating to insurance investment are complex, but can be mastered. Where a fund is not directly eligible, it might be possible to repackage it in an elegant, efficient and not too costly manner.

1 Background

Each day, German insurance companies and pension funds have to invest more than 1billion Euros. Fund managers and investment banks which structure fund products for the German market need products that are eligible for the premium reserves of German insurance companies.
Insurance companies need stable returns from their capital investments to be able to fulfil their statutory and contractual payment obligations. Huge losses in the bear markets of 2001/2002 have diminished their appetite for risky investments and they have shifted their focus from stocks to bonds. Low interest rates, however, have forced them to look for products with low volatility and still higher returns; many have started thinking about investing in hedge funds.
Insurance regulation of eligible assets can at times seem unstructured; to understand the regulation of insurance investments, one needs to be aware of the historical context: clever repackaging techniques have often frustrated the efforts of regulators to curb the use of speculative products.

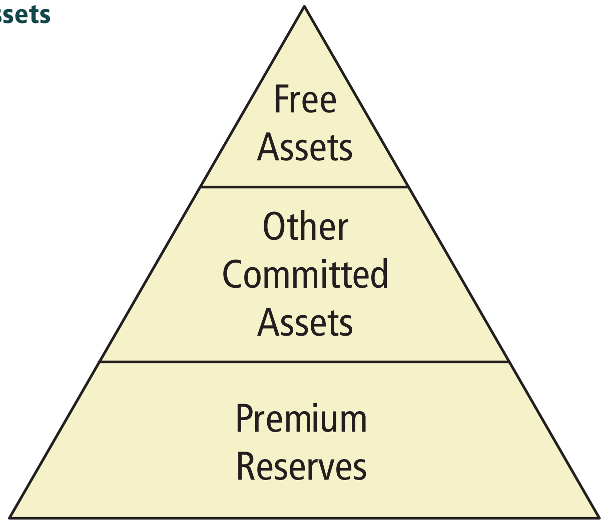
2 Regulatory framework

In Germany, insurance companies are typically constituted either as stock corporations or as corporations in the form of mutual insurance associations (Versicherungsvereine auf Gegenseitigkeit). In addition, there are public corporations or statutory bodies that are authorised to conduct insurance business, all of which are legal entities in their own right.

2.1 Free assets

German insurance companies may freely dispose only of a small part of their assets, the 'free assets' or freies Vermögen -- and then only when the disposition can be seen to be related to insurance business.

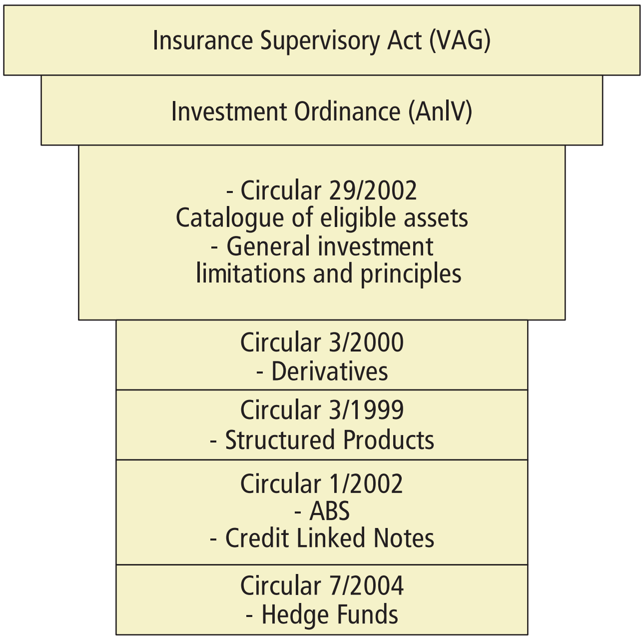
Assets



2.2 Committed assets

The larger part is regarded as 'committed assets' or gebundenes Vermögen -- i.e. assets required to fulfil potential claims of policyholders -- under the Insurance Supervisory Act (Versicherungsaufsichtsgesetz) (VAG).
When they invest their committed assets, German insurance companies must comply with Section 54 of VAG. This stipulates that they have to invest in assets that are liquid and safe; and that they invest the whole portfolio according to the principles of risk diversification and profitability.
Section 54 VAG contains a catalogue of permitted investments. It deals mainly with the formal quality of assets (such as bonds, Schuldscheine, securities, investment funds) and contains virtually no prerequisites with regard to the economic

quality of the investments.
Further details as to the quality of the eligible investments can be found in the recently amended 'Regulation on investment of committed assets of insurance companies' or Anlageverordnung (AnlV), and in several circulars.



Primary and secondary insurance regulation

There are two sub-sets of committed assets: the 'premium reserves' and the 'other committed assets' of an insurance company.

2.2.1 Premium reserves

The premium reserves (the former Deckungsstock -- now called Sicherungsvermögen) represent the bigger and more important part of the committed assets of traditional life insurance companies. They are a separate fund subject to statutory protection to ensure that the insurance company can at all times fulfil its obligations to policyholders.
The premium reserves are a counterpart to the actuarial reserves (Deckungsrückstellungen) and the further reserves that appear as liabilities on the balance sheet. In value, they must equal the sum of the actuarial reserves and all claims on insurance benefits at the time. The value is separated from the further assets of the life insurance company and should increase alongside liabilities.
The assets in premium reserves are not attachable by the general creditors of an insurance company; the claims of policyholders are thus secured in the event of insolvency. The premium reserves are supervised by a trustee or Treuhänder, who ensures that they are disposed of only in compliance with legal restrictions.
The premium reserves have to be managed separately and must be held in custody at the place where the insurance company is seated. Exemptions are permissible only with the approval of the German Federal Financial Services Authority (Bundesanstalt für Finanzdienstleistungs-aufsicht) (BaFin).

2.2.2 Other committed assets

The VAG contains detailed provisions on "other committed assets". However, for product devel-opers and sales people the distinction between premium reserves and other committed assets is practically irrelevant.

3 General investment principles

Section 54 (1) VAG outlines the general investment principles for committed assets of an insurance company. (See BaFin-Circular 29/2002.) The type of business and the insurance company's structure has of course to be taken into account. The key focus is on:

- safety;
- profitability;
- liquidity;
- diversification.

3.1 Safety

The safety of investments is essential for the quality of the insurance coverage. Only secure investments ensure performance of insurance policies. As a general rule, speculative investments are not permissible, as safety means first of all safeguarding an investment's nominal value. This criterion does not, in fact, create a significant obstacle: Section 54 VAG and the AnlV both contain a large number of investments generally considered to be speculative (such as stocks, private equity funds and hedge funds). Only where primary or secondary legislation specifically prohibits a particular investment -- such as commodity derivatives -- speculative investments cannot be pursued.

3.2 Profitability

Investments of an insurance company must be profitable, i.e. the investments must result in sustained proceeds, taking into account the principles of safety and liquidity as well as the status of the capital markets. This applies to each investment and to the entirety of investments. There is no requirement to achieve a specified minimum profit, but investments which are not deemed likely to make a profit are not permissible.

As all investments are made to create returns, this criterion rarely has an impact on an investment, and becomes relevant only in the case of combined products where one element of the product does not deliver a yield.

3.3 Liquidity

The insurance company must be able to fulfil due payment obligations without undue delay. Its assets must therefore be invested in such a manner that an adequate part can be liquidated at short notice.

This requirement does not generally prohibit non-liquid investments, since the VAG and the AnlV expressly permit illiquid investments such as private debt, closed-ended and unlisted funds as well as investments in real estate. For some investments, such as closed-ended funds, special rules apply, aiming to ensure that the lack of liquidity does not have a negative effect on policyholders.

3.4 Location of investments

Where the committed assets cover insurance-related reserves or versicherungstechnische Rückstellungen concerning risks located in the EEA, or life insurance contracts concluded in the EEA, the committed assets may in general only be located in the EEA. However, 5 per cent of premium reserves and 20 per cent of other committed assets that fall within this category may be located outside the EEA.

Where fund investments are concerned, the regulator "looks through" the fund structure to the underlying assets to determine where the assets are located.

4 Eligible fund investments

The VAG and the AnlV contain an exhaustive list of eligible investments, among them:

- bonds and money market instruments
- oans (to certain qualifying borrowers or collateralised)
- asset-backed securities
- shares
- other equity participations/interests in enterprises
- real estate.

All of these investments can be purchased directly; they can also be purchased through investment funds, some of which are mentioned in the Act:

- companies investing into real estate and real estate funds
- UCITS (Undertakings for Collective Investment in Transferable Securities) invested according to the principles of risk diversification and subject to sufficient public supervision
- hedge funds.

Investments in assets not mentioned in the VAG and AnlV are subject to permission by the BaFin - this is granted on a temporary basis and for exceptional cases only.

4.1 Opening clause

An insurance company may invest up to 5 per cent of the premium reserves and up to 5 per cent of the other committed assets in assets not set forth in the above catalogue, under an "opening clause" ("Öffnungsklausel"). With the BaFin's prior approval, the 5 per cent limit can in exceptional cases be extended up to 10 per cent.

Insurance companies are in general reluctant to use the opening clause for regular investments. They tend to keep it in reserve for investments made in unwittingly breach of the insurance company's investment restrictions.

4.2 Securities investment funds

The AnlV allows investments into German securities funds. Foreign open-ended securities funds -- funds that have their registered seat in the EEA with in-vestment restrictions similar to those in the UCITS Directive -- are also eligible investments. (By open-ended, we mean funds where the investor has the right, at all times, to redeem shares against repayment of their share of the NAV.) To be eligible, the fund's assets must be kept in custody by a depository bank or custodian.

The AnlV permits investments into securities funds which in turn invest a small portion of their assets into hedge funds or real estate funds. These "mixed funds" or "super funds" give small institutional investors access to the whole investment universe in just one fund vehicle. These funds are currently quite popular in Germany.

Securities investment funds are often established for one insurance company alone; these are known as "special funds". The insurance company, represented on the investment committee, has an influence on the investment policy and, thus, may ensure compliance with statutory investment principles.

In the case of securities investment funds where the insurance company is not represented on the investment policy committee, the insurance company must analyse the reports of the investment company -- looking in particular to see whether there has been compliance with the principle of investment safety. If securities investment funds are rated by a recognised rating agency, the ratings must be taken into account.

In the past, insurance companies invested their assets almost exclusively through special funds, hardly ever through public mutual funds. They now more and more often invest in public mutual funds (because of requirements laid down by IFRS accounting rules). The eligibility does not depend on whether the fund is registered for public distribution in Germany.

In practice, this means that under the heading "securities funds", insurance companies can invest in:

- equity funds
- bond funds
- money market funds
- funds of securities funds.

4.3 Equity funds

Large case as well as small and mid-cap funds are eligible investments.

Insurance companies may only invest up to 35 per cent of their committed assets into "risk as-sets", which comprise shares, subordinated bonds and other equity participations. Indirect in-vestments through funds are taken into account when calculating the 35 per cent quota.

4.4 Bond funds

Fixed income funds can be purchased, but important restrictions apply.

First, indirectly held assets also have to comply with the principle of investment safety. In the case of investments in investment fund shares, this principle applies not just to the shares as a whole, but to each individual asset included in the fund. If, therefore, only a predominant part of the fund's assets is safe, this will not suffice. The insurance company must examine regularly whether the fund's management complies with the principle of safety in its investment policy.

In principle, all securities in a fixed income fund held by an insurance company must have an investment grade rating; non-investment grade rated securities can only be added "to a small extent". High yield instruments are by law not eligible investments -- but the insurance company can apply for a special exemption.

Despite these restrictions, many insurance companies invest in high yield bond products, including funds. How can they do this? They reach an agreement with the BaFin that these investments shall be considered "risk assets" (to which the above 35 per cent quota applies). In other words, if the insurance company is willing to use the 35 per cent quota usually reserved for equity investments for high yield debt, the BaFin will typically give its consent to such investment.

Now, the BaFin has issued a new draft circular which allows an insurance company to invest up to 5% of its assets into high yield debt investments fund an investment would also be taken into account for the 35% equity quota.

Secondly, insurance companies can invest into debt securities which are not traded on an organised market in the EEA; certain percentage limits apply, however. For instance, an insurance company must not invest more than 5 per cent of its committed assets directly or indirectly in bonds which are not traded on an organised EEA market.

4.5 Money market funds

Since the revision of the UCITS directive, money market funds also qualify as UCITS funds; they are eligible investments for an insurance company, if the fund is based in the EEA.

4.6 Funds of security funds

Note that a fund of securities funds may only invest into target funds; these, according to their articles, may in turn only invest an aggregate 10 per cent of their assets in other funds.

4.7 Hedge funds

Before 2004, German insurance companies were not allowed to invest their committed assets in hedge funds. Some did, however -- either within the 5 per cent limit of the opening clause or through structured products and participation notes. Since August of 2004, they have officially been allowed to invest in hedge funds. The hedge funds must be based either in Germany or in the EEA; and direct and indirect investments must not exceed 5 per cent of the premium reserves and 5 per cent of the other committed assets of the insurer.

The 5 per cent limit also applies to other eligible investments related to German and non-German funds pursuing a hedge fund investment policy (e.g. structured products referring to hedge funds). Circular 7/2004 sets out the detailed requirements (alongside the provisions of the VAG and the AnlV).

4.7.1 The hedge funds circular

In the first part of circular 7/2004, the BaFin refers mainly to the investment restrictions of the AnlV and introduces a number of additional limitations. In particular, structured products (e.g. index certificates) relating partly to hedge funds and partly to other investments must contain a clearly definable connection between the hedge fund part and the other investments. If this cannot be demonstrated, the structured product is not an eligible investment for an insurance company.

An insurance company will not be able to invest more than 1 per cent of its committed assets in any one single hedge fund -- this investment restriction relates back to the requirement in section 113(4) Investment Act (Investmentgesetz) that a fund of hedge funds may not invest more than 20 per cent of its assets in one target hedge fund. Insurers are also not allowed to invest into more than two funds managed by any one fund manager.

These limitations have been criticised by the Association of Investment Companies in Germany, the BVI or Bundesverband Investment und Asset Management. The BVI argues that an insurance company's investments are already limited to just 5 per cent of both the premium reserves and the other committed assets, and that there is no need for further risk diversification.

The second part of the circular deals with the structuring of the investment process and risk management. An insurance company must have at its disposal the appropriate staff and organisational structure to assess the profitability and security of its hedge fund investments. If not, it must not invest in hedge funds.

The BaFin quotes details of the information required regarding the investment company launching the hedge fund, the hedge fund's depository bank, the fund manager and the hedge fund itself. The insurance company must constantly monitor compliance by the hedge fund's management with investment restrictions. It must, therefore, have personnel familiar with investments in hedge funds or at least with a good knowledge of derivatives risk management.

The insurance company may delegate its risk management in relation to hedge funds to a credit institution or securities services enterprise (Wertpapierdienstleistungsunternehmen).

The credit institution and the securities services enterprise must not be the hedge fund's depository bank (or prime broker) and must have the required personnel and organisational structure.

Circular 7/2004 imposes detailed further restrictions on the investments of German insurance companies in hedge funds. As a consequence, insurance companies as investors in German single hedge funds (which cannot be distributed publicly in Germany) must incur further personnel and infrastructure costs on the risk management of their investments in hedge funds. This may not lead to more security, but will certainly result in greater cost and therefore less profit.

4..7.2 Outlook

At the moment, German insurance companies are not enthusiastic about investments in hedge funds. A recent study on German institutional investors revealed that only 8 per cent of the insurance companies taking part were interested in hedge funds. (See Deutsche institutionelle Anleger und ihr Anlageverhalten 2005, Südprojekt.) Even those insurance companies envisage relatively small investments in single hedge funds. This could be the result of the relatively bad performance of hedge funds in 2004 and the administrative hurdles created by circular 7/2004 -- or it could be a long-term trend.

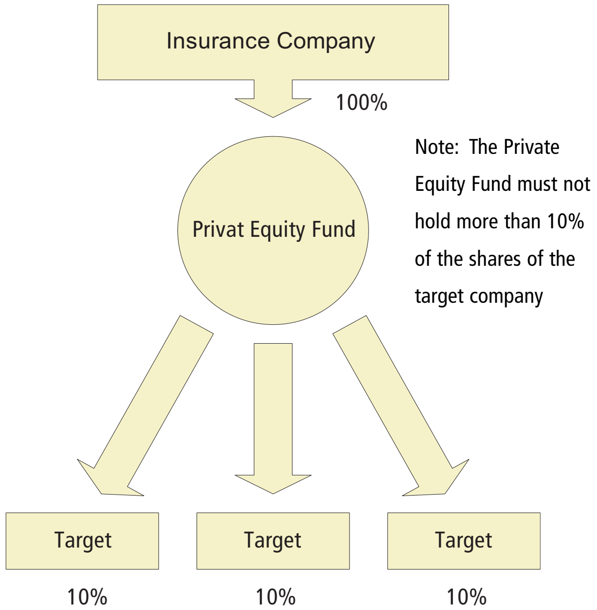
4.8 Private equity funds

Private equity funds were in vogue until 2001, fell from favour for a few years, and are now back on the scene. A market study has shown that insurance companies now consider private equity investments very attractive, in particular in comparison with other investments. (See Deutsche institutionelle Anleger und ihr Anlageverhalten 2005, Südprojekt.) They have invested roughly 2 per cent of their committed assets into private equity. More than 40 per cent of all insurance companies hold private equity investments, most of them through private equity funds.

When the AnlV was revised a few years ago, one reason was to facilitate private equity fund investments. Insurance companies are allowed to invest in both German and non-German (EEA-based) private equity funds and funds of funds.

German private equity funds are often established in the form of limited partnerships. Foreign funds sold to German investors are -- for tax reasons -- often structured as SICAVs or SICARs.

A German insurance company is allowed to acquire only 10 per cent of the shares or interests in corporations or partnerships. However, to facilitate private equity investments the regulator stated in circular 29/2002 that a "look through" approach should be adopted in the case of corporations or partnerships that invest all of their assets into other companies. It is possible, therefore, to establish a private equity fund just for one German insurance company, which fund can then acquire 10 per cent of the shares of the target companies.



Private equity funds, owing to the long-term nature of their investments, are almost always established as closed ended funds. However, one of the overriding concerns of the regulator is the liquidity of an insurance company's assets.

Consequently, when the first draft of the AnlV was published, investments in closed-ended funds were entirely prohibited. Following protests from the industry, the regulator eased this re-striction by stating in circular 29/2002 that a closed-ended fund could be purchased, if its shares are either traded on a regulated market with sufficient liquidity or if the shares are predominantly purchased by institutional investors.

4.9 Real estate funds

A maximum of 25 per cent of the premium reserves and up to 25 per cent of the other commit-ted assets may be invested in real estate (and equivalent assets, shares in real estate investment companies, etc.).

The property must be located in the EEA. Where investments are in real estate companies, such company's scope of activities must be solely the acquisition, the construction or the management of not more than three properties located in EEA countries, or equivalent assets. The insurance company is obliged to instruct an appraiser to assess the adequacy of the purchase price.

Instead of making direct investments, an insurance company can invest up to 25 per cent of the committed assets, including the premium reserves, in real estate investment funds established in the EEA that predominantly invest in property in the EEA.

5 Taxation issues

For German tax purposes, it will help to distinguish between "white" (fully transparent), "grey" (semi-transparent) and "black" (non-transparent) fund treatment.

5.1 White funds

The qualification and the tax consequences of investments in a fund depend on whether, and to what extent, the fund complies with the publication and filing requirements of the German Investment Tax Act.

5.1.1 Publication requirements

A fund is deemed transparent (white fund) if it fully complies with the tax reporting and publication requirements in section 5 of the Investment Tax Act (ITA).

Investors in Germany must receive specified information on a per share basis for each distribution (or, where the fund retains income, within a four-month period after the end of the business year at the latest).

They must be told the distribution amount (to at least four decimal places, and encompassing distribution of income as well as repayment of principal) and the amount of distributed income (to at least four decimal places). They must also be provided with detailed information about the fund's sources of income, in particular whether it is derived from interest, dividends, derivatives, rental income, etc.

5.1.2 Tax consequences

As far as corporate investors are concerned, distributions and deemed distributions (once they qualify as a fully transparent fund) are generally taxable. However, where dividend portions, and portions of capital gains derived from the sale of shares in corporations, are contained in such (deemed) distribution, section 8b of the German Corporate Income Tax Act provides a 95 per cent tax exemption for these portions.

5.1.3 Special rules apply for insurance companies

The tax exemptions in section 8b German Corporate Income Tax Act for capital gains and dividends do not apply, if the shares in the fund are held by credit institutions or financial institutions allocating the shares to their trading books (section 8b para 7, German Corporate Income Tax Act). If the shares in the fund are held by life or health insurance companies as investment assets, section 8b does not apply. As a result, any dividend portion, as well as a capital gains portion, will be subject to tax.

If the fund publishes all the required information -- with the exception of the positive (or negative) percentage rate of the investment share's value allotted to income deemed "stock earnings" (Aktiengewinn); and the redemption price of the investment share -- and if the investment share then goes up for sale or redemption, the favourable tax treatment of the "semi-income system" or Halbeinkünfteverfahren does not apply; neither does section 8b.

Where shares in the fund are held by credit institutions or financial institutions allocating such shares to their trading books (or by life or health insurance companies as investment assets), there is no tax exemption -- irrespective of whether the above conditions are met.

5.2 Grey funds

A fund is considered semi-transparent, if all reporting requirements are met, apart from those which, if reported, would exempt the investor from taxation.

5.3 Black funds

If the reporting requirements (see "Publication requirements" above) are not met at all, the fund will be considered non-transparent. The proceeds derived from this investment are then heavily taxed.

German investors in non-transparent funds are taxed at regular rates on all distributions of the fund, plus the lower of (a) 70 per cent of the increase of the net asset value in the calendar year or (b) 6 per cent of the last determined redemption price of the fund. (If a redemption price is not determined, the stock exchange or market price will be used as a basis in calculating the above.)

5.4 Interim profits

Domestic and foreign investment funds (with, at the moment, the exception of single hedge funds and fund of hedge funds) have to determine and to publish their interim profits on a daily basis. (Decree of the German Federal Ministry of Finance, May 2005.)
Interim profits are fully taxable at a corporate investor's level. If they are not determined and published, 6 per cent of the last redemption price will be used as the basis for calculating the interim profits on a pro rata basis.

5.5 Loss treatment

As life insurance companies in particular tend to generate continuing losses (based upon making accruals and/or based upon an exercise of a right under a life insurance contract by third parties), these losses can be credited against other income. When investing in a non-transparent fund, for example, the resulting income could be compensated by such continuing losses. The "punitive taxation" experienced under the non-transparent fund taxation regime would thus, in practice, not play a role. Where it's a matter of carrying forward losses, these are generally deductible (up to € 1 million); where the losses exceed the € 1 million threshold, 60 per cent is deductible.

6 Repackaging

A large number of investment funds still cannot be purchased by an insurance company for its committed assets -- such as funds based outside the EEA, closed-ended securities funds and private loan funds. There are other cases where, although an investment is possible, the tax consequences are negative (because of the applicability of the Investment Tax Act or of the Foreign Tax Act or Außensteuergesetz).
In the last few years, repackaging instruments have been introduced in the German market to help overcome these investment or tax restrictions. Some of these instruments (such as certificates) were developed for private investors, but insurance companies now use them as well. Other devices (such as participation notes or Genuss-Scheine), are used for repackagings to specifically address the requirements of insurance companies.

Such repackaging is possible as the BaFin does not generally "look through" the repackaging instrument as to the eligibility or quality of the underlying asset (it does this only in those cases where the law or a circular provides for a look-through).

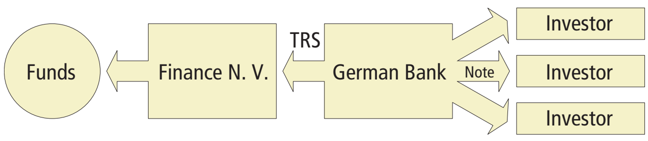
6.1 Using an SPV

The legally simplest way of repackaging otherwise non-eligible assets is to establish a corporation (one could call it an SPV), the shares of which are purchased by the insurance company and which invests its assets into the target investment.
It has always been the regulators' view that it does not "look through" the SPV to the underlying assets. That can work to the benefit of the insurance company -- but also against it. For instance, where the SPV invests in real estate, the investment is still considered an equity investment, unless the requirements of "real estate companies" are met.
Repackaging through an SPV has one considerable setback: an insurance company must not own more than 10 per cent of the share capital of another company. There are ways around this obstacle (using an agio, for example) but these ways are -- while practised successfully in the past -- certainly a circumvention of the legislator's intention.

6.2 Using certificates

A certificate is a bearer bond, the return of which is linked to an index, the performance of a basket of assets or even an individual asset.
Where the asset is, for instance, a private loan fund, the certificate gives its holder a participation in the return generated -- including the upside and the downside. These products are immensely popular among German private investors (largely for tax reasons); some insurance companies also invest in them.
The index certificate or "note" works as shown below:
It is still an open question whether an index certificate is a structured product. This matter of its qualification is important, not only in determining the accounting of the product, but also in de-ciding its eligibility for committed assets. Structured products must only be purchased for the committed assets if they

are designated as "simple" structured products. This is only



the case if the following criteria are met:

- the structured product comprises a cash instrument that is tied to one or several derivative(s), which are equivalent and belong to the same risk category
- there is a guarantee of the capital invested
- negative return on the investment is excluded
- neither the obligation to deliver nor to take delivery is imposed on the investor.

A structured product (according to BaFin-Circular 3/99) is a type of investment where a cash instrument is tied to one or more derivatives(s), thus forming a legal and economic unit.
One could argue that an index certificate contains an embedded derivative, insofar as it "derives" its value from an underlying index (or assets comprising the index). On the other hand, the documentation for index certificates does not mention the derivative element, and one could thus argue that it does not qualify as a structured product.
It is probably for this reason that the BaFin ruled a few years ago -- much to the surprise of investors and their advisers -- that index certificates on a hedge fund linked index would not qualify as structured products.
The BaFin added to the confusion, when it referred to indirect hedge fund investments (through certificates; and through participation notes, which do not contain derivatives) as "structured products". For this to be true, the "structured product" would have to come with a full capital guarantee - but the BaFin does not draw this same conclusion (see BaFin-Circular 7/2004 on hedge fund investments).

6.3 Using participation notes

To avoid the uncertainties associated with certificates -- and to avoid the requirement to provide for a capital guarantee -- some banks have developed participation notes or Genuss-Scheine, which essentially work like a tracking stock. The performance of the participation note is linked to the performance of an underlying asset, which can be either the fund itself or a total return swap related to a fund.
Participation notes have so far only been used to repackage hedge funds; they are, in fact, an elegant way to repackage all types of funds.
The issuer of a participation note is ideally a bank; corporate issuers are, under certain circumstances, also eligible.

7 Conclusion

Investment funds - in particular mutual funds - are an attractive investment for German insurance companies. Non-German investment funds from specialist managers are currently much in demand. The German rules relating to insurance investment are complex, but can be mastered. Where a fund is not directly eligible, it might be possible to repackage it in an elegant, efficient and not-too costly manner.

Background

1 Funds@Work® AG

As an internationally operating strategy consultant, specialised in the asset management industry, we accompany our clients in the current change process.
The increasing modularisation of the value chain in our industry requires state of the art methodology in differentiating our clients, standardisation skills to increase the pie for all market participants and a clear expertise in creating network structures by forming strategic alliances. Those three drivers of future developments are the core of our business which is complemented by a unique and systematic market intelligence based on a proprietary industry model.

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Jan Altmann graduated in Economics and communication sciences and joined Funds@Work AG in 2002. He is consulting international and domestic clients all along the value chain of asset management in strategic issues. Before he came to Funds@Work, he has developed, implemented and marketed the ETF-segment (exchange traded funds) for Deutsche Börse AG. The XTF- Exchange Traded Funds® segment is today the market leader in Europe. At the same time he was also responsible for marketing and development of the other equity primary Market segments and was part of the mutual fund project at Deutsche Börse. Before that, he acted as press spokesman for Deutsche Börse for Neuer Markt and Xetra and, in the same position, for the chemical company BASF covering financial issues. Jan Altmann writes a regular column on standards in FundsEurope, a monthly pan-European magazine for the fund industry and is in the editorial board of the Journal of Indexes.

2 The Norton Rose investment funds practice in Germany

Norton Rose Germany acts for major investment companies – both national and international. We regularly assist such companies in introducing their products to the German market and in establishing distribution networks throughout Germany. Another core part of the team's work is the structuring of investment funds, including private equity funds and hedge funds.

Areas of expertise include:

Registration of UCITS and non-UCITS

We are particularly active in assisting foreign and domestic investment fund companies in registering all different types of UCITS and non-UCITS funds for public distribution in Germany under the German Investment Act. We have excellent long-standing contacts with the BaFin, which have often proved helpful in solving and avoiding problems and delays.

Distribution agreements

We assist our clients in the preparation and the conclusion of distribution agreements and general terms and conditions, and are familiar with the standard distribution agreements of all major fund distributors.

Paying, representative and agency agreements

We advise on the conclusion of paying, representative and agency agreements, and we have drafted standard agreements for our clients.

Revision of marketing material

We have wide-ranging experience in revising marketing material and advising on German shareholding disclosure procedures.

Sales offices

Our team has considerable experience and expertise in the registration and the establishment of sales offices.

Tax team

The Norton Rose Frankfurt office includes an experienced tax team specialising in financial services. The partners of the tax and banking teams are experienced in working together to ensure efficient, effective and co-ordinated advice for our clients.

Translation team

A team of translators specialising in funds-related translations is available, as part of our banking department in Frankfurt.
They support us in preparing translations of sales prospectuses and financial reports as well as any requisite marketing material.

Further services

As a matter of course we offer a full service in all fund-related issues, such as labour law, distribution law, trade mark rights, IT and IP law.

The team

The Investment Funds Team at Norton Rose Germany is led by banking partner Frank Herring and tax partner Dr Uwe Hartmann. They and their teams focus primarily on funds work. In addition, we have a number of specialised paralegals and translators who have dealt with funds issues for years.

Credentials

The German equivalent of Legal 500, the JUVE Handbook, ranks the investment funds practice of Norton Rose in Germany on the same level as, or higher than, all major City firms, confirming the success of our practice. Banking partner Frank Herring has been mentioned as a 'leading practitioner' in the investment funds area for the past four years.

Contact details

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Frank Herring is a partner in the Frankfurt office of Norton Rose. He is head of the banking and capital markets team and specialises in investment funds law. Following legal studies in Kiel, Paris, London and New York, Frank took the bar exam in 1996 and joined the German law firm Oppenhoff & Rädler. In 2000, he became head of banking regulation and investment funds at Linklaters Oppenhoff & Rädler.

In 2001, Frank joined Norton Rose. Here, he built, together with his team, a very highly regarded fund practice, focussing on fund distribution and alternative investments.

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