The German Master-KVG model

Entering the German market and access to institutional investors

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## Contents

**Introduction** ................................................................................................................................................... 1

**Overview: Master-KVG-market in Germany** .................................................................................................. 2

  - Types of investors ........................................................................................................................................... 2
  - Purpose of the Master-KVG model .................................................................................................................. 3
  - Master-KVGs in Germany ................................................................................................................................. 3

**Structure of the Master-KVG model** ............................................................................................................. 4

  - The structure at a glance ................................................................................................................................. 4
  - Who are the parties? ....................................................................................................................................... 4

**How does the structure work in practice?** .................................................................................................... 6

  - Set-up process ................................................................................................................................................ 6
  - (Foreign) asset manager perspective .............................................................................................................. 7

**What is the legal framework?** ..................................................................................................................... 8

  - Overview: Contractual relationships ............................................................................................................. 8
  - Contractual basis ............................................................................................................................................ 8
  - Liability .......................................................................................................................................................... 9

**What are the most important regulatory requirements?** .............................................................................. 10

  - Regulatory background ................................................................................................................................. 10
  - What does it mean from a contractual perspective? ..................................................................................... 10
  - What does it mean in practice? ..................................................................................................................... 10

**Key contacts** ............................................................................................................................................... 11

**Our locations** ............................................................................................................................................ 12
Introduction

This Note provides an overview of the structure, legal framework and set-up of the so-called ‘Master-KVG model’ in Germany. In the past, there has been significant growth in the use of the Master-KVG model and this growth is likely to continue.

The Master-KVG model is the preferred investment platform for German institutional investors, predominantly insurance companies, that already have a German (special) fund in place. The Master-KVG model provides such investors with a useful instrument to elect the best or preferred asset managers for each of their asset classes.

Foreign asset managers frequently use the Master-KVG model to manage a German investment fund without establishing a German management company.

In this Note we examine the structure of the Master-KVG model and provide answers to the most frequently asked questions.
Overview: Master-KVG-market in Germany

Types of investors

The Master-KVG model is particularly suitable for the management of German special funds. The majority of managed assets in German special funds are held by three types of investors: insurance companies, pension funds and industrial enterprises.

(Data as of 31 May 2016; source: BVI)

Insurance companies are the predominant type of investor and the latest data tracking the assets of insurers and pension funds to date predicts that this predominance will remain the case for the foreseeable future:

Purpose of the Master-KVG model

An investor in a German special fund may establish a number of fund segments for different asset classes (such as equities, fixed income, alternatives) and will elect its preferred asset manager for the portfolio management of each different asset class. Legally, the investor has only one special fund and the Master-KVG will delegate the portfolio management of the fund segments to different asset managers. As a consequence the portfolio management services will be rendered by different asset managers.

The Master-KVG processes the administrative services for the German special fund and its segments; thus, the risk and administrative tasks remain with only one entity, the Master-KVG. For German institutional investors, the Master-KVG model is a very effective way to consolidate its investments on one administrative platform. This is known in Germany as the concept of “fund segmentation” and is used by most special fund investors (73% of all German special funds are “segmented”):

(Data as of 31 December 2015, source BVI)

Master-KVGs in Germany

German Master-KVG services are offered by, among others, Allianz Global Investors, Bayern Invest, Helaba Invest, INKA, Metzler Investment, Societe Generale Securities Services and Universal-Investment.
Structure of the Master-KVG model

The structure of the Master-KVG model consists of a minimum of five parties: (1) one or more (German) investor(s), (2) the Master-KVG, (3) the custodian, (4) one or more asset manager who seeks to provide portfolio management services to German investor(s) and (5) the investment fund in corporate or contractual form (including its possible fund segments).

The structure at a glance

Who are the parties?

Investor

The investor is usually an institutional investor (either a regulated or unregulated corporate entity). The investor must be a professional or a so-called semi-professional investor within the meaning of the German investment law. A professional investor is a professional client within the meaning of MiFID. A semi-professional investor is, in particular, any investor who commits to investing at least EUR 10 Mio, or who commits to investing at least EUR 200K and has a sufficient level of experience/expertise (assessment and documentation by Master-KVG is required).

The investor holds shares/units of the investment fund. Depending on the legal structure of the fund, the assets of the investment fund are owned by the Master-KVG or jointly by the investor(s).

Master-KVG

The Master-KVG is a German regulated investment management company (UCITS-management company and/or AIFM) authorised and supervised by the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, the “BaFin”) and licensed under the German investment law. From a legal perspective, the Master-KVG is the manager of the investment fund (including its segments) and has ultimate responsibility for the portfolio management, risk management and administrative services. In practice, however, the Master-KVG limits its services to, inter alia, pre-trade controlling, monitoring investment limits, risk management and administrative services.
Custodian

The custodian is a (German) regulated entity (usually a German credit institution/bank supervised by the BaFin and German Bundesbank and licensed under the German Banking Act) appointed by the Master-KVG for the safekeeping of the assets. The applicable German Investment law as well as the written depository agreement, which must be concluded between the Master-KVG and the custodian, entail a number of rights and duties.

In addition to the task of safekeeping, the custodian has a number of monitoring and controlling rights and obligations with respect to the supervision of portfolio management. The custodian is involved in technical matters with respect to trading and settlement. Therefore, the custodian is an important player and party for the asset manager in the course of rendering the portfolio management services. The asset manager, in particular its back-office-department, is forced to collaborate and work with the custodian not only during the set-up, but also during the day-to-day running of the business.

Asset manager

The asset manager is normally a regulated legal entity and is responsible for the portfolio management of the fund. The asset manager can be an entity licenced under the AIFMD, the UCITS Directive or MiFID. If the asset manager is domiciled in a non-EU country, it must be licensed or registered for the purpose of asset management or financial portfolio management, subject to supervision, and the cooperation between the BaFin and the respective supervisory authority of the non-EU asset manager must be assured.

If the aforementioned licence or registration requirement is not fulfilled (e.g. in case of real estate asset manager), the Master-KVG is only permitted to delegate the portfolio management to an unregulated entity with prior approval from the BaFin.

In practice, the institutional investor will select the asset manager. From a legal perspective, however, the Master-KVG appoints the asset manager and enters into a delegation agreement, known as the investment management agreement or the “IMA”. Usually, such IMA is based (more or less) on the template IMA provided by the German Investment Funds Association (the “BVI”).

Investment fund

The investment fund under the German Master-KVG model is very often a contractual fund which has no legal personality. In this case, the Master-KVG acts for the (joint) account of the investors of the investment fund and the asset manager acts on behalf of the Master-KVG. However, the investment fund may also be structured in corporate form (which is then an investment company).
How does the structure work in practice?

Set-up process

In practice, the Master-KVG model is usually established as follows:

Step 1: Election of an asset manager

The institutional investor usually selects an asset manager. In practice, an asset manager may either actively pitch or will be invited to pitch for the portfolio management function. In either case, the asset manager will submit a request for proposal to the institutional investor by which it introduces itself and provides information on its competences, resources and know-how, amongst other things, in order to convince the institutional investor.

‘Selection’ in this regard does not mean that the institutional investor enters or will enter into an agreement with the asset manager. Rather, ‘selection’ means that the investor will instruct the Master-KVG to delegate the portfolio management function for the respective investment fund in whole, or in part, to its preferred asset manager at a later stage.

Step 2: Set-up of a German investment fund

The Master-KVG sets up (or has already set up) an investment fund in Germany for institutional investors. The investment fund can, generally, be any type of fund within the meaning of the German Investment Law. In Germany, the Spezial-AIF mit festen Anlagebedingungen (literally, ‘special AIF with fixed investment rules’) is the most widely used vehicle and its greater flexibility and fewer regulatory requirements means that it can offer a wider range of opportunities than a mutual fund.

Step 3: Appointment of a custodian

From a legal perspective, the Master-KVG must appoint a custodian because a German investment fund requires the appointment of a custodian, commonly a German bank.

Step 4: Due diligence process

Prior to the delegation of portfolio management to the asset manager, the Master-KVG must conduct a comprehensive due diligence on the asset manager. The purpose of this is to assess whether the asset manager is authorised and capable of taking over and fulfilling the tasks and duties to be delegated, in particular from a regulatory perspective.

In the course of the due diligence process, the Master-KVG will request a number of pieces of information, documents and evidence to demonstrate that the asset manager is a licensed entity and complies with the applicable regulatory requirements.

Such due diligence is, in practice, very time consuming. After the delegation, the Master-KVG is also obliged to conduct a similar process on at least an annual basis.

The due diligence process is audited and monitored by external auditors as well as by the BaFin and is subject to close supervision. The Master-KVG takes -and must take- it very seriously. If a Master-KVG comes to the conclusion that the relevant asset manager is not a reliable partner due to regulatory reasons, it will not hesitate to refrain from entering into an IMA with the asset manager irrespective of the institutional investor’s selection.

Step 5: Delegation of portfolio management

Finally, the Master–KVG will, from a legal perspective, appoint the selected asset manager and delegate the portfolio management function totally or in part to it. Such appointment takes place by entering into an IMA.
Please note that the five step approach described above is not cast in stone. The investment fund could already be established or the custodian already appointed. However, the Master-KVG must complete the due diligence process before the asset manager is appointed.

(Foreign) asset manager perspective

The Master-KVG model provides (non-German) asset managers approaching the German market with the opportunity to set-up a German fund without the need to establish a German regulated management company. The (non-German) asset manager has to collaborate with a German Master-KVG which has the necessary licence and the administrative platform in place to set up and manage a fund. Nevertheless, the above mentioned process remains the same.
What is the legal framework?

Overview: Contractual relationships

The legal relationship between the Master-KVG and the institutional investor is governed by the fund rules (general and special rules; *Allgemeine und Besondere Anlagebedingungen*), the investment guidelines and the applicable German investment law. Legally, the institutional investor and the Master-KVG enter into an investment agreement (*Investmentvertrag*) pursuant to which the Master-KVG manages the pooled assets of the investment fund.

If the investment fund is a special fund, the investor will usually sign a so-called tri-party-agreement (*Dreier-Vereinbarung*) with the Master-KVG and the custodian, in which it may deviate from the applicable German investment law, or agree on special, individual, investor-orientated provisions to the extent legally possible.

The Master-KVG and the asset manager enter into an IMA and affiliated documents. Pursuant to the IMA, the asset manager renders portfolio management services on behalf of the Master-KVG.

From a legal perspective, the IMA is an outsourcing agreement which must meet a number of regulatory requirements.

The Master-KVG enters into a custodian agreement (*Verwahrstellenvertrag*) with the custodian. Pursuant to this agreement the custodian is obliged to take on responsibility for the safekeeping of the assets. Under German investment law the custodian has certain control and monitoring rights and duties.

Contractual basis

There are a number of documents with which a German domiciled Master-KVG will provide the asset manager prior to rendering the portfolio management services – these include an IMA, operating memorandum and service level agreement (the “OM”/“SLA”), general and special fund rules, investment guidelines and other operational documents.

Such agreements and documents contain numerous references to the applicable German investment law. Many of the general and specific references pursuant to German investment law are required both legally and in a regulatory context. In such cases, negotiation of these clauses is limited to a certain extent (and often not negotiable at all).

However, it is often possible to soften the language. Other references, in particular the references to German Civil law, are fully negotiable between the parties. We typically provide non-German clients with a memorandum explaining the general references to German laws and regulations that are contained in the IMA and/ or the other documents mentioned above, and the impact of these rules for our clients as non-German asset managers.

Such regulatory requirements are, in particular, the German Capital Investment Code (*Kapitalanlagegesetzbuch, KAGB*), the Delegated Regulation (EU) No 231/2013, the German Securities Trading Act (*Wertpapierhandelsgesetz, WpHG*), German Data Protection Act (*Bundesdatenschutzgesetz, BDSG*), the Derivate Ordinance (*Derivateverordnung, DerivateV*), the German Capital Investment Conduct and Organisational Regulation (*Kapitalanlage-Verhaltens- und Organisationsverordnung, KAVerOV*), the Minimum Requirements for Risk Management in Asset Management Companies (*Mindestanforderungen an das Risikomanagement von Kapitalverwaltungsgesellschaften, KAMaRisk*).
Liability

The Master-KVG is merely a fund administration platform and responsible only for fund accounting and other administrative functions not linked with portfolio management. However, from a regulatory perspective the Master-KVG is responsible for the observation of German investment law requirements and takes charge of, for example, fund accounting, controlling or risk management.

Furthermore, the Master-KVG is compelled to install a compliance function. When a Master-KVG manages an investment fund, it acts in its own name but for the joint account of the investors of the investment fund. This means that the Master-KVG is liable for breaches of investment limitations and other errors. In this case, liability claims by the investors may arise.

The asset manager will be liable towards the Master-KVG if its investment decisions breach the investment restrictions and the investment fund suffers damage. It is difficult to rely on the concept of contributory negligence of the KVG and very often KVGs refuse to limit the liability of direct and foreseeable damages.

Generally, when a KVG purchases securities for or the joint account of the investors of an investment fund it manages it will not be liable if the broker through which the securities are bought defaults on its payment or delivery obligation. A liability can only arise if the KVG has failed properly to instruct the broker or to monitor the broker’s performance. Nevertheless, most Master-KVGs try to impose on the asset manager full liability for a default of a broker instructed by the asset manager. There is a range of ways by which liability may be mitigated, including liability only for a failure to properly instruct the broker, an exclusion of liability should the broker default because of insolvency or a complete exclusion of liability if only brokers on a pre-approved list are used.
What are the most important regulatory requirements?

Regulatory background

When a German Master-KVG delegates functions that are essential for providing its services (i.e., portfolio management or risk management), such delegation must not adversely affect the orderliness of such business or services, the Master-KVG’s managers’ abilities to manage and monitor them, or BaFin’s right to audit and ability to monitor them.

A delegation must 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.

The delegation must also not interfere with the effectiveness of supervision by the Master-KVG. In particular, it shall neither interfere with the Master-KVG acting in the best interests of its investors nor impair the management of the investment funds which is in the interests of its investors.

Certain German institutional investors like smaller insurance undertaking, pension funds and Versorgungswerke need to comply with provisions of the Anlageverordnung the respective BaFin guidance thereto (Kapitalanlagerundschreiben). If the Anlageverordnung applies, additional requirements must be met by a fund in order to qualify as an eligible investment for the investor.

What does it mean from a contractual perspective?

A Master-KVG must contractually ensure that it can give instructions to the asset manager and must integrate the outsourced areas in its internal monitoring and audit processes.

As a consequence, most Master-KVGs impose rules of conduct on the asset managers. 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 IMA and the OM/SLA contain provisions pursuant to which the Master-KVG can take over the management of the investment fund if it is necessary to protect the investors’ interests.

The KAMaRisk sets specific requirements on Master-KVGs when investing into loans. These requirements will also be contractually forwarded to the asset manager in the IMA.

What does it mean in practice?

The Master-KVG is entitled and obliged to audit and monitor the asset manager. In the course of their ongoing and ad hoc supervisions the Master-KVG may ask for reports on the portfolio management and internal control processes, information on conducted internal and external audits of the asset manager, data for investor reporting (e.g. VAG-reporting), data for regulatory reporting (e.g. under EMIR or AIFMD). Ultimately, the Master-KVG reserves the right to enter the premises of the asset manager.

There is no standard in Germany with respect to the scope of monitoring and supervision. After the implementation of AIFMD, a number of German Master-KVGs started to foster their monitoring set-ups and controlling systems. As a consequence of this, asset managers were obliged to disclose more information than before. Even confidential information, e.g. information from an internal or external audit report, might be disclosed to a Master-KVG.
Key contacts

It is important to us that our clients have an individual point of contact with the team, and feel that they are able to contact us at any time. We get great pleasure from finding the best possible solutions to legal problems and thinking outside the box. Key contact biographies can be viewed at https://www.simmons-simmons.com.

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