



Updated FAQ eligible assets for German investment funds

In October 2009 the German Federal Financial Supervisory Authority published an update of its FAQs regarding eligible assets for various types of German open end investment funds, in particular German UCITS funds.

One of the key questions for German investment companies and their domestic and foreign portfolio managers and advisors is the permissibility of specific investments or investment strategies for a regulated investment fund. Moreover, the classification of an asset as a specific type of eligible asset is important for monitoring compliance of the regulated investment fund with applicable investment limits. As a general rule the German Investment Act (Investmentgesetz – InvG) lists the following eligible assets: securities, money market instruments, derivatives, bank deposits, real property, participations in real property companies, investment fund units, participations in PPP project companies, precious metals, loan receivables, participations in enterprises and silent participations. However, the different fund types of the InvG may each invest only in certain eligible assets.

In October 2009 the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin) published an update of its FAQ eligible assets. The FAQ eligible assets set out the BaFin's view on specific questions related to eligible assets for investment funds subject to the InvG. Most of the FAQs refer to UCITS funds (Part 1) but there are also FAQs dealing with special funds for institutional investors (Part 2) and with so called other funds (Sonstige Sondervermögen) a fund type with a rather broad range of eligible assets which has been introduced in the InvG in December 2007 (Part 3). With regard to UCITS funds the Commission Directive 2007/16/EC of 19 March 2007 (the Directive 2007/16/EC) clarifies

the requirements for eligible assets of UCITS funds. The FAQs regarding UCITS funds also take this directive into account.

In the following pages we will provide a summary of the various FAQs answered by the BaFin. The FAQs refer to various topics concerning eligible assets which are not necessarily related to each other. To determine whether a specific product constitutes an eligible asset or a specific type of eligible asset depends on many aspects which are not all addressed in the FAQs. Please do not hesitate to contact us if you want to discuss certain aspects in more detail.

Part 1 – UCITS funds

1. Certificates as transferable securities

Certificates that are directly and fully linked to the performance of an underlying asset (so called Delta 1 certificates) are considered transferable securities provided that (i) the underlying asset is not a derivative and (ii) it fulfils the criteria set out in article 2 paragraph 2 point (c) of the Directive 2007/16/EC. These criteria include the limitation of potential losses to the invested amount, sufficient liquidity, reliable valuation, availability of appropriate information, negotiability, compliance with the fund's investment objectives or investment policy, adequate risk management and reference to the performance of other assets. According to the BaFin Delta 1 certificates constitute neither derivatives nor financial instruments embedding derivatives.

2. Delta 1 certificates on precious metals

Delta 1 certificates where the underlying asset is a precious metal could be considered transferable securities if they do not provide for physical settlement. Moreover, the general features of transferable securities as set out in article 2 paragraph 2 point (c) of the Directive 2007/16/EC must be fulfilled.

3. Certificates as derivatives or financial instruments embedding derivatives

Certificates are considered derivatives or financial instruments embedding derivatives if their underlying asset is a derivative or if they are not fully linked to the performance of the underlying asset. Therefore, such a certificate is subject to a look-through approach. According to the German Derivatives Regulation for Investment Funds (Derivateverordnung – DerivateV) each component of such certificates has to be analysed for the purposes of calculating the market risk and compliance with statutory investment limits.

However, the rule above does not apply to Delta 1 certificates where the underlying asset is the future price of crude oil. According to the BaFin it is standard market practice that Delta 1 certificates on crude oil refer to the future price of crude oil. Plus according to the BaFin it has to be taken into account that these Delta 1 certificates do not apply leverage. Therefore, Delta 1 certificates on the future price of crude oil are considered transferable securities provided they comply with article 2 paragraph 2 point (c) of the Directive 2007/16/EC.

4. Structured products under sections 27, 28 DerivateV

The BaFin points out that sections 27 and 28 DerivateV which deal with structured products have to be interpreted in accordance with the Directive 2007/16/EC. Therefore, structured products under sections 27 and 28 DerivateV mean structured products embedding derivatives. The derivative component of a structured product has to fulfil the criteria set out in article 10 paragraph 1 points (a) to (c) of the Directive 2007/16/EC. These criteria include the following:

- by virtue of the derivative component some or all of the cash flows that otherwise would be required by the transferable security which functions as host contract, can be modified according to a specific variable and therefore vary in a way similar to a stand-alone derivative;

- the economic characteristics and risks of the derivative component are not closely related to the economic characteristics and risks of the host contract; and
- the derivative component has a significant impact on the risk profile and pricing of the transferable security.

Delta 1 certificates where the underlying asset is not a derivative do not fall into the category of structured products embedding derivatives.

5. Financial indices composed of assets which are not eligible for UCITS funds

According to section 51 InvG a UCITS fund may invest into derivatives which are based on financial indices as set out in article 9 paragraph 1 of the Directive 2007/16/EC. Subject to further requirements article 9 paragraph 1 of the Directive 2007/16/EC allows a reference to indices which are composed of assets which would not be eligible assets for a direct investment by a UCITS fund (eg commodity indices, precious metals indices, real estate indices). In general such indices must be sufficiently diversified. However, the diversification requirement regarding the components of the index does not apply if the UCITS fund itself complies with the 5/10/40 per cent limits regarding the relevant derivatives which are linked to such an index.

6. Mixed approach under section 6 paragraph 2 DerivateV?

As a general rule German investment companies will take a qualified approach in order to calculate the market risk limit that applies if a fund invests into derivatives. However, section 6 paragraph 2 DerivateV allows a German investment company to use a simplified approach for the calculation of market risk if a fund invests only in certain 'plain vanilla' types of derivatives or financial instruments embedding derivatives. The BaFin emphasises that this exemption from the qualified approach cannot be granted anymore if a fund invests into a single derivative that is not comprised in the list of plain vanilla derivatives set out in section 6 paragraph 2 DerivateV. Even if the investment company installed other monitoring instruments, like stress tests, the use of the simplified approach would not be permissible under the current DerivateV in such cases. The BaFin points out that it is considering an amendment of the DerivateV

in this respect and that such an amendment is likely to occur.

7. Certificates on hedge funds or hedge fund indices

A UCITS fund may invest in Delta 1 certificates with a hedge fund or a hedge fund index as underlying asset provided that the requirements of article 2 paragraph 2 point (c) of the Directive 2007/16/EC are fulfilled. The BaFin points out that the risks related to such certificates must be adequately reflected by the risk management process of the UCITS fund.

8. Quanto Delta 1 certificates and certificates with capital protection

Delta 1 certificates that are protected against currency risks (Quanto Delta 1 certificates) qualify as transferable securities provided that the requirements of article 2 paragraph 2 point (c) of the Directive 2007/16/EC are fulfilled. The same applies to certificates for which repayment of capital is guaranteed with a participation grade of 100 per cent. If repayment of capital of a certificate is guaranteed with a participation grade of less than 100 per cent the certificate is considered a financial instrument embedding a derivative.

9. Bonus certificates and discount certificates

Bonus certificates and discount certificates are considered financial instruments embedding a derivative. Therefore, they are subject to a look-through approach. According to the DerivateV each component of such a certificate has to be analysed for the purposes of calculating the market risk and compliance with statutory investment limits.

10. Bonds linked to an inflation index

Bonds linked to an inflation index qualify as transferable securities provided that the requirements of article 2 paragraph 2 point (c) of the Directive 2007/16/EC are fulfilled. Moreover, the underlying inflation index has to be accepted as an inflation benchmark by the respective central bank.

11. Commodity derivatives

Commodity derivatives do not qualify as eligible assets under article 8 paragraph 5 of the Directive 2007/16/EC.

12. Options on Delta 1 certificates on crude oil

In general a UCITS fund may not invest into financial instruments linked to an ineligible underlying asset if such financial instrument is leveraged or has a delta not equal to 1. Options on Delta 1 certificates with crude oil as underlying asset do not constitute an eligible asset for a UCITS fund since they apply leverage.

13. Units in closed end funds

Units in closed end funds qualify as transferable securities ie an eligible asset for UCITS funds if they fulfil the criteria set out in article 2 paragraph 2 points (a) and (b) of the Directive 2007/16/EC. These criteria include amongst other things risk management, reliable valuation, availability of appropriate information, negotiability, supervision of the asset manager, corporate governance and limitation of potential losses to the invested amount.

With regard to a limitation of potential losses, the BaFin requires that the potential loss is limited to the amount paid for the investment in the closed end fund. Moreover, the BaFin clarifies that a limitation of potential losses would still be given if the invested amount has to be paid in several tranches into the closed end fund, provided that on an aggregated basis the capital contributions of the UCITS fund do not exceed the invested amount.

With regard to the requirement of corporate governance of a closed end fund, the BaFin refers to the following factor set out in the guidelines of the Committee on European Securities Regulators (CESR) concerning eligible assets for investments by UCITS (the CESR guidelines): the unit holders' right to vote in the essential decision-making processes of the closed end fund and to control the investment policy of the closed end fund.

14. Look-through approach for units in closed end funds?

In order to determine whether units in closed end funds are eligible assets for a UCITS fund, an analysis of the investments made by the closed end fund itself (look-through approach) is not necessary if the units in the closed end fund fulfil the requirements set out in article 2 paragraph 2 points (a) and (b) of the Directive 2007/16/EC. In such cases the closed end fund may also invest into assets which are not eligible assets for a UCITS fund.

Moreover, the BaFin clarifies that even if such a closed end fund invested in derivatives, the units of the closed end fund would not qualify as financial instruments embedding a derivative. However, the risks related to units in such a closed end fund have to be adequately reflected in the risk management of the respective UCITS fund.

15. Cat bonds

According to the BaFin a UCITS fund must not invest into bonds if income payments or redemptions under the terms and conditions of the bond are linked to the occurrence of a specified catastrophe event (cat bonds).

16. Money market instruments as structured products embedding a derivative?

The BaFin points out that money market instruments qualify as structured products embedding a derivative if they fulfil the criteria set out in article 10 paragraph 2 of the Directive 2007/16/EC. This provision requires that the money market instruments fulfil one of the following criteria:

- they have a maturity at issuance of up to and including 397 days;
- they have a residual maturity of up to and including 397 days;
- they undergo regular yield adjustments in line with money market conditions at least every 397 days; or
- their risk profile corresponds to that of financial instruments which fall into one of the categories above.

Furthermore, article 10 paragraph 2 of the Directive 2007/16/EC requires that the money market instruments can be sold at limited cost in an adequately short time frame and that accurate and reliable valuations systems are available. This enables the UCITS fund to calculate a net asset value in accordance with the value at which the financial instrument held in the portfolio could be exchanged between knowledgeable willing parties in an arm's length transaction and which are based either on market data or on valuation models including systems based on amortised costs.

Finally, article 10 paragraph 2 of the Directive 2007/16/EC requires that the money market instruments contain a component which fulfils the following criteria:

- by virtue of the derivative component some or all of the cash flows that otherwise would be required by the money market instrument which functions as host contract can be modified according to a specific variable and therefore vary in a way similar to a stand-alone derivative;
- the economic characteristics and risks of the derivative component are not closely related to the economic characteristics and risks of the host contract; and
- the derivative component has a significant impact on the risk profile and pricing of the money market instrument.

If a money market instrument contains a component which is contractually transferable independently of the money market instrument, the money market instrument will not be regarded as embedding a derivative. However, such component constitutes a separate financial instrument as set out in article 10 paragraph 3 of the Directive 2007/16/EC.

17. Asset-backed securities as financial instruments embedding a derivative?

The BaFin refers to the CESR guidelines which do not regard asset-backed securities (ABS) as financial instruments embedding a derivative. Moreover, the BaFin points out that for these purposes it is irrelevant whether the underlying pool of receivables is actively managed or whether the ABS are issued in a true-sale or synthetic securitisation transaction.

According to the BaFin the rule above does not apply if a potential loss may exceed the invested amount or if the underlying pool of receivables is not sufficiently diversified. In such case the relevant ABS are regarded as financial instruments embedding a derivative. As a result these ABS would be subject to a look-through approach and each component would have to be analysed for the purposes of calculating the market risk and compliance with statutory investment limits under section 27 DerivateV.

18. Qualification of 'waterfall' in ABS transactions

The BaFin does not regard the waterfall structure used in ABS transactions as a derivative. According to the BaFin the waterfall structure must be considered as a subordination agreement.

19. Impact of collateral on issuer risk or issuer limits

According to the BaFin non-compliance with the limitations relating to issuers which have to be taken into account by UCITS funds under section 60 InvG cannot be permitted based on the provision of collateral.

20. No diversification of collateral

The BaFin clarifies that the diversification obligation does not apply to collateral received by UCITS funds for the mitigation of counterparty risk under section 22 paragraph 6 DerivateV. Thus UCITS funds may also receive only a single type of collateral.

21. Delta 1 certificates with one underlying asset

The BaFin qualifies the acquisition of Delta 1 certificates issued by different issuers as violating the risk diversification obligation if all certificates are based on one single underlying asset.

22. Synthetic short selling

According to the BaFin synthetic short selling through derivatives is permissible if either the underlying asset is held in the UCITS fund as cover or another asset is held in the UCITS fund as cover, provided that:

- the other asset is highly liquid;
- the other asset can be used to acquire the underlying asset at any time; and
- the additional market risk associated with the type of transaction is adequately measured.

In the case of cash settled derivatives the underlying asset must not be held as cover by the UCITS fund. Rather cash, liquid debt instruments with adequate protection mechanisms (eg haircuts) or other highly liquid instruments can be used as cover. These guidelines derive from the Commission Recommendation 2004/383/EC.

23. Permissible investments for UCITS index funds

The BaFin does not restrict fund managers of UCITS index funds with respect to their strategy to replicate the relevant index. Index funds can replicate an index also through the use of derivatives provided that:

- the use of derivatives is sufficiently disclosed in the fund rules;
- the prospectuses highlight the additional risks associated with the use of derivatives eg counterparty risk; and
- the risk management addresses the additional risks.

Part II – Special funds

1. No application of public funds investment restrictions

The BaFin confirms that except for the limitation of permissible assets under section 2 paragraph 4 InvG the investment restrictions applicable to public funds do not apply to special funds if the requirements under section 91 paragraph 3 InvG (eg investors' consent) are fulfilled. Hence, special funds may also invest into derivatives with underlying assets which are not permissible for UCITS funds.

2. No application of fund categories to special funds

The fund categories existing for public funds do not apply to special funds, except for special funds established and managed as hedge funds or funds of hedge funds.

3. Investments in cascade funds, funds of hedge funds and special funds

The BaFin confirms that special funds may also invest into investment funds which are not permissible for public funds, eg cascade funds, funds of hedge funds or foreign special funds if the requirements under section 91 paragraph 3 InvG (eg investors' consent) are fulfilled.

4. Investment limits

The BaFin clarifies that special funds with investors' consent are permitted to deviate from investment limits which apply to public funds, except for the investment restrictions expressly specified in section 91 paragraph 3 InvG. The mandatory investment limits set out here include a reference to the investment restriction set out in section 90h paragraph 4 sentence 1 InvG. In this respect the BaFin points out that such reference to section 90h paragraph 4 sentence 1 InvG shall be read to only apply to the limit of 20 per cent of the fund's NAV with respect to investments into participations in enterprises (Unternehmensbeteiligungen).

5. Master feeder funds

Special funds that comply with the requirements under section 91 paragraph 3 InvG can be set up as feeder funds investing only into one master fund provided that the master fund complies with the risk diversification obligation.

6. Total return swaps

The BaFin takes the view that a special fund is also permitted to enter into one total return swap if:

- the returns paid into the fund arise from a risk diversified asset pool; and
- the respective counterparty provides sufficient collateral in accordance with section 22 paragraphs 6 and 7 DerivateV.

Part III – Other funds

1. Master feeder funds

The BaFin takes the view that under current law other funds within the meaning of section 90g InvG cannot be structured as master feeder funds. This may change, however, when UCITS IV is implemented.

2. Investments into derivatives

Other funds may invest up to 30 per cent of their NAV into derivatives whose underlying assets do not fall under the list of permissible underlying assets in section 51 paragraph 1 sentence 1 InvG. The BaFin takes the view that this threshold has to be calculated on the basis of the market value of the underlying exposure. Furthermore the market risk potential must not more than double through the use of derivatives and the fund's risk management must cover the additional risks.

3. Investment into only one OTC derivative with permissible underlying assets

Other funds are permitted to invest into only one OTC derivative with permissible underlying assets under section 51 paragraph 1 sentence 1 InvG provided that:

- the underlying assets are risk diversified; and
- the counterparty provides sufficient collateral in accordance with section 22 paragraphs 6 and 7 DerivateV.

Part IV – Other

1. Derivative regulation

The BaFin announced an update of the DerivateV taking into account the Directive 2007/16/EC and the respective CESR guidelines. The BaFin confirms that if its published comments on the application of the DerivateV conflict with the interpretation of the DerivateV in accordance

with the Directive 2007/16/EC the latter interpretation will prevail.

2. Participations in enterprises

The BaFin clarifies that participation in enterprises within the meaning of section 2 paragraph 4 number 9 and 11 InvG comprise all investments into companies which grant profit participation rights and administration rights (eg voting and information rights). So units in closed end funds may also be permissible investments provided that they grant administration rights.

3. Real estate companies vs. participations in enterprises

The BaFin describes the difference between participations in real estate companies within the meaning of section 2 paragraph 4 number 6 InvG and participations in enterprises within the meaning of section 2 paragraph 4 number 9 and 11 InvG as follows:

- companies qualify as real estate companies if according to their articles of association they are only permitted to acquire real property, participations in real estate companies and/or such assets necessary for the management of real property; and
- according to the BaFin companies that conduct further activities (eg the management of hotels or the acquisition of real estate loans) do not qualify as real estate companies.

For further information please contact

Dr. Thomas Emde
T +49 69 27 30 82 31
E thomas.emde@freshfields.com

Dr. Alexandra Dreibus
T +49 69 27 30 82 46
E alexandra.dreibus@freshfields.com

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