

THE GERMAN INVESTMENTAKTIENGESELLSCHAFT
(CLOSED-END FUND):
INVESTMENT ALTERNATIVE OR LEGISLATIVE FAILURE?

GEORG F. THOMA* &
KAI-UWE STECK**

1. INTRODUCTION

On March 24, 1998, the German federal government enacted the *Dritte Finanzmarktförderungsgesetz* [3rd Financial Markets Improvement Act] ("FMFG").¹ The FMFG became effective April 1, 1998 and, among other things, established the *Investmentaktiengesellschaft* ("Investment-AG"), or "closed-end fund," as a new form of investment company under the *Gesetz über Kapitalanlagegesellschaften* [German Investment Company Act] ("KAGG").² The German federal government created Investment-AGs with the intention of stimulating the supply of capital to German companies by opening up new business areas to professional asset managers in Germany. The legislators expected the amendment to lead to an additional supply of venture capital for German high-growth companies, because an Investment-AG is not required to redeem its shares and was therefore considered particularly well-suited for venture capital investing.³

Investment companies raise capital from investors and issue securities in return (so-called "investment certificates"). The in-

* Shearman & Sterling, Managing Partner-Germany.

** Shearman & Sterling, Associate.

The Authors thank Paul S. Schreiber, Partner, and Francois Martino, Associate, Shearman & Sterling, New York for their helpful comments.

German citations have been verified by the Authors and not by the *University of Pennsylvania Journal of International Economic Law*.

¹ *Dritte Finanzmarktförderungsgesetz* [3rd Financial Markets Improvement Act], v. 24.3.1998 (BGBl. I S.529) [hereinafter FMFG].

² *Gesetz über Kapitalanlagegesellschaften* [German Investment Company Act], v. 9.9.1998 (BGBl. I S.2726) [hereinafter KAGG].

³ Arguments for the FMFG, Bundestags Drucksache 13/8933 of 1998, at 2, 62 [hereinafter BT-Drucks]; JÜRGEN BAUR, in *HANDBUCH DES KAPITALANLAGERECHTS* § 18, no. 32 (Heinz Dieter Assmann & Rolf A. Schütze eds., Supp. Mar. 1999).

vestment company's assets are invested in a diverse pool of securities based on the principle of reducing risk through diversification. In the case of the traditional "open-end" investment company, if an investor decides to withdraw from the fund, he or she is entitled to return his or her investment certificates to the issuer in exchange for a payment equal to the proportion of the fund's net asset value ("NAV") represented by those certificates.

While the redemption obligation of open-end funds is advantageous for investors, it constitutes a significant burden for fund management, which must reserve sufficient liquidity to fulfill redemptions on short notice.⁴ Fund managers cope with the redemption obligation in a number of different ways. Some fund managers maintain large cash reserves. However, cash holdings, including money market securities, generally generate low returns and adversely affect the fund's performance. Other fund managers meet redemption requests by selling the fund's portfolio securities. However, if there is insufficient liquidity for the securities, it may not be possible to sell the securities at all or they may only be sold at a substantial loss. Furthermore, retail investors tend to redeem more during market downturns, when securities markets usually have the least liquidity.⁵

In contrast, Investment-AGs are not obliged to redeem their shares.⁶ Instead, an investor may dispose of his investment only by selling the shares in a secondary market or upon liquidation of the fund.⁷ Because Investment-AGs do not redeem their shares, and also because they issue new shares only occasionally (similar

⁴ Decisive for the procedures are the conditions of the contracts approved by the German banking authority (*Bundesaufsichtsamt fuer das Kreditwesen*) [BAKred], which also provide for the conditions under which fund shares are redeemed. See § 15, KAGG, para. 3 g. A stay of redemption is only permitted as an exception pursuant to the strict requirements of section 11, KAGG, paragraph 2, sentence 2.

⁵ As a reaction of fund investors to the bear market in August 1998, stock funds in the United States had to cope with net outflows of U.S. \$11.2 billion for the first time since 1990. Cf. Benedikt Fehr, *Amerikas Investmentgesellschaften profitieren van Zug hin zur Aktie*, FRANKFURTER ALLGEMEINE ZEITUNG, Nov. 2, 1998, at 38 (stating a practical example).

⁶ Pursuant to section 51, KAGG, paragraph 2, sentences 2 & 3, only voting bearer shares.

⁷ Therefore, the shares have to be registered for official listing or trade in the regulated market on a national stock exchange. See § 61, KAGG, para. 3. This is also a special opportunity for the German regional exchanges to remain dominant as secondary markets by introducing a segment for closed-end funds. Cf. Jürgen Baur, in 5 BANKRECHT UND BANKPRAXIS no. 9/24 (Thorwald Hellner & Stephan Steuer eds., 2000) (providing references to the government's arguments).

to a conventional stock corporation), they are called closed-end funds.⁸

The lack of liquidity in venture capital investments is the principle justification for creating Investment-AGs. German high-growth companies requiring venture capital are rarely exchange-listed companies.⁹ In addition, the securities of high-growth companies seeking venture capital are generally not fungible and lack an active trading market. Therefore, venture capital investments are illiquid investments per se. An open-end fund that makes venture capital investments may not be able to redeem investment certificates. Consequently, open-end funds are not ideal sources of venture capital for high-growth companies. Investment-AGs, on the other hand, depend less on liquid markets due to the absence of a redemption obligation. They are not forced to sell portfolio holdings unexpectedly to pay off investors.¹⁰ This makes Investment-AGs particularly well-suited for making venture capital investments or, for that matter, making investments in other illiquid markets, such as emerging markets.¹¹

In spite of the functional advantages of the Investment-AG, the legislators' expectations have so far remained unfulfilled. No Investment-AG has been created thus far in Germany. One reason for this is the legal framework of the KAGG, which runs counter to the purposes behind the Investment-AG. This Essay discusses the weaknesses of the KAGG. This Essay also suggests a method for creating an Investment-AG that is both practical and meets the requirements of the KAGG, thereby increasing the potential level of acceptance for the Investment-AG.

⁸ For details on the difference between closed-end/open-end funds and the corporate and contract type, see JÜRGEN BAUR, *INVESTMENTGESETZE 1 Teilband*, Einl. I no. 76 (1997); RÜDIGER PÄSLER, *HANDBUCH DES INVESTMENTSPARENS 7* (1991).

⁹ See *infra* Section 2.2. (discussing the problem of the permitted investment objects).

¹⁰ Cf. THOMAS PAUL & RÜDIGER PÄSLER, *DAS DEUTSCHE INVESTMENTRECHT* introduction no. 84 (1999) (stating that closed-end funds need not effect "fire-sales" to obtain liquidity).

¹¹ Karrie McMillan, *Issues and Opportunities for Closed-End Funds*, in *THE '40 ACT INSTITUTE 1999*, at 277, 279 (PLI Corp. L. & Practice Course, Handbook Series No. 1112, 1999); Diane E. Ambler, *Roundtable on the Role of Independent Investment Company Directors: Issues for Independent Directors of Bank-Related Funds, Variable Insurance Product Funds, and Closed-End Funds*, 55 *BUS. LAW.* 205, 233 (1999).

2. SHORTCOMINGS AND POTENTIAL REMEDIES

The *Bundesverband Deutscher Investmentgesellschaften* [German Investment Company Institute] ("BVI") was initially open-minded about including Investment-AGs in the KAGG. However, during the hearings leading to the enactment of the FMFG, the BVI expressed wariness regarding several points of the amendment.¹² The BVI's concerns were ignored.

2.1. Discount after IPO ("Market Discount Phenomenon")

The BVI's main criticism of the Investment-AG focuses on a pricing phenomenon that is well known in the United States. An empirical study by the U.S. Securities and Exchange Commission ("SEC")¹³ shows that, immediately after their initial public offering ("IPO"), shares in closed-end funds have a tendency to trade at a discount to the fund's NAV (a so-called "market discount phenomenon").¹⁴ This is the reason why few, if any, traditional closed-end funds have been issued in the United States in recent years.

Because of the market discount phenomenon, the BVI rejected the creation of closed-end funds partially out of fear of being accused by the media of conducting some kind of "Cheating Scheme." The BVI feared that, based on the following analysis, the market discount phenomenon could also occur in Germany.

Under section 63, KAGG, paragraph 2, an investment company must offer its shares to the public at a price that corresponds to the investment company's NAV per share plus a markup for transaction expenses specified in the investment company's articles of as-

¹² Statement on the FMFG, public hearing of the financing committee of November 12, 1997, Finanzausschuss Drucksache no. 510, 13th election period, Protocol no. 93.

¹³ Study by the Office of Economic Analysis, SEC, *The Post-Offering Price Performance of Closed-End Funds* (July 21, 1989); see also KAI-UWE STECK, *REGULIERUNG VON US-AMERIKANISCHEN INVESTMENTGESELLSCHAFTEN* 78 (2000) (describing the empirical study).

¹⁴ In 1997, approximately seventy-one percent of the closed-end funds in the United States were traded at a discount. In 1996 that number had grown to eighty-three percent of all funds. The average discount amounted to 6.87%. In extreme cases, the discount amounted to thirty percent.

At times of falling interest rates, some closed-end funds, such as bond funds, have traded at a premium to NAV. Closed-end funds also may trade at a premium if the fund manager has an exceptional record or if the fund provides an indirect way of investing in "private investments" or underlying "hedge funds" that would not otherwise be available.

sociation. The NAV per share¹⁵ is derived by dividing the net value of the investment company's assets by the number of issued shares.¹⁶ After the investment company sells its shares in an IPO, free market forces determine the trading price of the shares. It may be that shortly after the IPO, the same share representing the same NAV per share (*ceteris paribus*) may be available on the market at a price far below the IPO price.¹⁷ If this market discount phenomenon were to appear in Germany, the initial subscribers, who bought at the IPO price, would be in for an unpleasant surprise. Whether this justifies the accusation of a "Cheating Scheme" or not shall be left open at this point. In any case, the industry would need to defend against the accusations.

2.1.1. Market Discount Phenomenon Causes

There are several possible causes for the market discount phenomenon. For instance, investors may discount the transaction expense markup that is included in the IPO price,¹⁸ or investors may have a general aversion against investing in companies, such as closed-end funds, that have a small market-capitalization.¹⁹ According to one treatise,²⁰ the market discount is not related to the quality of the management. But, as previously noted, some funds

¹⁵ According to section 63, KAGG, paragraph 3, the NAV is generally to be determined at least once a week and to be published in a sufficiently available business or newspaper without undue delay.

¹⁶ This provision is comparable to the special provisions for the issuance of shares in special security asset pools. See § 21, KAGG.

¹⁷ There are indications that so-called "vultures" in the United States have specialized in the taking over of funds of this type by acquiring a majority of the fund at a discount and liquidating it. The goal of these transactions is to gain cheap access to the portfolio of a closed-end fund below its intrinsic value.

¹⁸ Periodic Repurchases by Closed-End Management Investment Companies; Redemptions by Open-End Management Investment Companies and Registered Separate Accounts at Periodic Intervals or with Extended Payment, Exchange Act Release Nos. 33-6948, 34-30967, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,022 (July 28, 1992).

¹⁹ Wendell M. Faria, *The Regulation of Closed-End Investment Companies*, in NUTS & BOLTS OF FINANCIAL PRODUCTS, at 293, 311 (PLI Corp. L. & Practice Course, Handbook Series No. 975, 1999).

²⁰ See Ronald J. Gilson & Reinier Kraakman, *Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate*, 45 STAN. L. REV. 985, 1005 (1993). U.S. investor protection representatives have different opinions. See, e.g., Craig Karmin, *Holder Activists Get a Whole Lot Of Shakin' Goin' On at Closed-Ends*, WALL ST. J., Oct. 4, 1999, available at 1999 WL-WSJ 24916362 (discussing the rights of activist shareholders in the United States).

do trade at a premium if the fund's manager has an exceptional track record.

Due to the IPO pricing procedures set forth in section 63, KAGG, paragraph 2, the IPO price cannot reflect subjective criteria, such as the quality of management. Under section 63, the IPO price is based only on the actual value of the fund's assets and the transaction expense markup. Any additional factors such as the investment experience, previous investment success, investment strategy, and the composition of the fund's management are not taken into account. Furthermore, the IPO price cannot reflect the composition and performance of the supervisory bodies, the investor structure, the range of the offered services, and the marketing abilities of an Investment-AG. But all of these factors will be reflected in the market price when the value of the shares is no longer based on section 63, KAGG but is instead determined by the market. Even though the market price will not be completely uncoupled from the fund's intrinsic asset value, it will not be directly tied to the fund's NAV.²¹ In this respect, the market price for shares of an Investment-AG does not differ from a conventional stock corporation's share price. The market price anticipates all influencing factors both positive and negative under transparent market conditions. The legislators anticipated that the market price for a share of an Investment-AG may not equal the Investment-AG's NAV per share. Accordingly, section 62, KAGG, paragraph 2, requires that the stock market prospectus state that the shares' NAV generally differs from its market price.

Section 64, KAGG, paragraph 1 permits an Investment-AG to repurchase its own shares as part of a price management measure if the shares' market price falls below ninety percent of its NAV. However, this repurchase right is unable to neutralize the market discount phenomenon when the discount is smaller.

We propose that the German federal government consider further amending the KAGG to permit Investment-AGs greater ability to repurchase their own shares as a method of counteracting

²¹ On the other hand, both the issue price and redemption price of open-end funds are determined by the open-end fund's NAV. According to section 21, KAGG, paras. 2 and 5, the redemption price of an open-end fund corresponds to the NAV per share, as determined by the deposit bank. The NAV per share is derived by dividing the NAV of the fund by the number of shares outstanding. The fund's NAV is determined every trading day based on the market prices of the fund's securities, subscription rights, and option rights plus the value of the fund's other assets and minus any loans or other liabilities of the fund.

the market discount phenomenon. The German federal government can find support for these measures from the effects of a regulatory provision²² adopted by the SEC in the United States.²³ In 1992, the SEC adopted Rule 23c-3 under the U.S. Investment Company Act of 1940 that permits certain closed-end funds to offer to repurchase its own shares at NAV every three, six, or twelve months and that permits all conventional closed-end funds to offer to repurchase its shares at NAV once every two years.²⁴ Closed-end funds that engage in these repurchase transactions are known as closed-end interval funds or hybrid funds.²⁵

2.1.2. IPO at Market Conditions

Another question is whether or not the statutory pricing procedure can be replaced by a market-oriented procedure such as book building.

According to the legislative history of the FMFG, section 63, KAGG, paragraph 2 incorporates the guiding principle of all investment funds in that the price at which an investment fund offers its shares, at least in the case of a public offering, must correspond

²² Repurchase Offers By Closed-end Companies, 17 C.F.R. § 270.23c-3 (2001).

²³ It has been said

[t]hat flexibility narrows the gap between the value of the WEBS [World Equity Benchmark Shares] and the underlying shares, or its net asset value . . . Shares of closed-end funds often trade at a discount . . . [A]n ongoing share-buyback program immediately lifted the per-share net-asset value and shrank the fund's discount. The buybacks, which began in October 2000, have helped raise the fund's share price by more than fifty percent.

Craig Karmin, *More-Efficient WEBS Provide Alternative to Closed-End Funds*, WALL ST. J., July 6, 1999, at R12, available at 1999 WL-WSJ 5459197; see also Ambler, *supra* note 11, at 234-37 (providing critical comment).

²⁴ Periodic Repurchases by Closed-End Management Investment Companies; Redemptions by Open-End Management Investment Companies and Registered Separate Accounts at Periodic Intervals or with Extended Payment, Exchange Act Release Nos. 33-6948, 34-30967, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,022 (July 28, 1992). For details on the variants not discussed hereinafter, see THOMAS P. LEMKE ET AL., 1 REGULATION OF INVESTMENT COMPANIES § 4.04 6 (1998); McMILLAN, *supra* note 11 at 286-94; STECK, *supra* note 13, at 74.

²⁵ On this subject Michael Berenson, *The Status of the Investment Company Act Study*, in A.L.I.-A.B.A. CONFERENCE ON LIFE INS. COMPANY PRODUCTS: CURRENT SEC., TAX, ERISA, AND ST. REG. ISSUES 61, 68 (1997); Elizabeth G. Osterman, *Distribution, Resale, and Repurchase of Securities by Closed-End and Open-End Hybrid Investment Companies*, A.L.I.-A.B.A. INVESTMENT COMPANY REG. & COMPLIANCE 189, 195 (1997).

to the intrinsic value allocable to the shares on the day that the investment fund accepts the public's unconditional subscription offers.²⁶ If section 63, KAGG, paragraph 2 is questioned, the guiding principle of investment funds appears to be undermined. But the legislators created the Investment-AG as a new investment vehicle, at least in Germany, which may possibly require its own guiding principle.

Persuading the legislative authorities to accept a market-oriented pricing procedure would require establishing sufficiently strong arguments to counteract the guiding principles currently in place. Under transparent issuing conditions, investors would be able to take into account criteria mentioned above regarding the fund's management, investment strategy, controlling mechanisms, and service, in addition to the intrinsic value of the initial assets of the fund. In most cases, the IPO price would not correspond to the intrinsic value of the fund's assets plus transaction expenses. However, it may not necessarily end up below that price. A question that should still be asked is: who would eventually bear the discount if, in spite of a market-oriented pricing procedure, the IPO price was below the NAV plus transaction costs? The answer to this question may be illustrated by looking at the incorporation procedure of an Investment-AG. Pursuant to section 51, KAGG, paragraph 5, an Investment-AG receives its operating license within the meaning of section 51, KAGG, paragraph 1 only if the paid-in registered capital amounts to at least EURO 1 million, the Investment-AG has its registered office in Germany, the managers are reliable and are qualified to lead the company, the articles stipulate that the fund may carry out only those activities listed in section 51, KAGG, paragraph 3 as well as immediately related ancillary activities, the articles correspond to the requirements of section 15, KAGG regarding the conditions of contract, and the Investment-AG has commissioned a deposit bank in accordance with the requirements of section 12, KAGG.

This shows that a stock corporation has to be incorporated or be in existence first (first step) before it may apply for an operating license (second step).²⁷ If the operating license is granted, at least

²⁶ For arguments favoring the FMFG, see BT-Drucks 13/8933, 130; § 21, KAGG, para. 1, sentence 1.

²⁷ The license application already has to contain corresponding information and documentation pursuant to section 51, KAGG, paragraph 4, in connection with section 32, Kreditwesengesetz, para. 1, sentence 2 [Banking Act], v. 9.9.1998

ninety percent of the investment shares have to be publicly offered within six months (third step).²⁸ According to section 51, KAGG, paragraph 6, the operating license may be revoked by the Federal Banking Supervisory Office (BAKred) if, within twelve months after such license has been granted, less than seventy-five percent of the Investment-AG's issued shares have been floated. The statute lists two non-exclusive examples that meet the requirements for a public offer: either a third party enters into an agreement with the Investment-AG's shareholders to offer their shares to the public,²⁹ or the Investment-AG's founders conduct a corresponding capital increase while waiving their own subscription right.³⁰

2.1.2.1. *Redistribution*

In practice, the first case involves a redistribution using an underwriting syndicate. The incorporators, most of whom in practice will be financial intermediaries, sell at least ninety percent of their original shares to the public. The underwriting banks operate as brokers based on a brokerage agreement pursuant to *Buergerliches Gesetzbuch* [German Civil Code] ("BGB")³¹ or acquire the original shares in order to sell these in their own name.³²

If, irrespective of the KAGG's statutory pricing procedure, the underwriting syndicate resells the shares at a price below the NAV per share, the former shareholders would bear the discount instead of the fund. The Investment-AG does not receive any new capital during the redistribution. It would be a contractual issue between the selling shareholders and the fund as to who will bear the transactional expenses relating to the underwriting.³³ Nonetheless, the

(BGB1. I S.2776) [hereinafter KWG]. A smooth licensing process generally lasts for three to four months after filing, i.e., brochure by the BVI for establishing a *Kapitalanlagegesellschaft*.

²⁸ § 61, KAGG, para. 1. As already stated, the public offer requires a prior stock exchange registration. See discussion, *supra* note 7. The exchange registration in turn requires a previous publication of the IPO prospectus pursuant to section 62, KAGG.

²⁹ § 61, KAGG, para. 2, no. 1.

³⁰ § 61 KAGG, para. 2, no. 2.

³¹ Bürgerliches Gesetzbuch [German Civil Code], v. 18.8.1896 (RGB1 S.195), as amended.

³² Ulrich Bosch & Wolfgang Gross, in 5 BANKRECHT UND BANKPRAXIS, *supra* note 7, at no. 10/288.

³³ The prohibition of contribution repayment (§ 57, AktG, para. 1) in the form of payment to a third party (nonshareholder) for account of the shareholder must

guiding principle for investment savings is not violated by redistribution at market prices. Pursuant to this guiding principle, the shares' issue price has to be equal to the intrinsic value of the shares on the day on which the Investment-AG accepts the public's non-conditional subscription offers. During the redistribution, however, the Investment-AG is not accepting the public's subscription offers. Only the selling shareholders commit themselves to transfer a certain number of their shares. The Investment-AG is generally not involved.³⁴ Consequently, the statutory pricing procedure protects the selling shareholders against market-related price risks but does not ensure adequate capital inflow for the Investment-AG. Conversely, an issue price that was not formed by the market increases the placement risk on the selling shareholders.

2.1.2.2. *Capital Increase with Subscription Right Exclusion*

In the second case mentioned above, the founders keep their original shares. With the founders' approval during a shareholders' meeting, the capital is increased by ninety percent while subscription rights are excluded³⁵ so that public investors eventually subscribe to the new shares.³⁶

After passing the capital increase resolution pursuant to section 182, AktG, paragraph 1, and filing the resolution for registration with the commercial register, pursuant to section 184, AktG, the fund finalizes the agreement with the new subscribers. This subscription agreement is created by a written declaration—subscription certificate pursuant to section 185, AktG, paragraph 1—in which the subscribers submit an offer to the fund to acquire a certain number of shares at a certain price, as well as the fund's subsequent acceptance of this offer. This subscription agreement establishes the subscriber's obligation to pay the capital contribution.³⁷

be observed. See Marcus Lutter, in *KÖLNER KOMMENTAR ZUM AKTIENRECHT* § 57, no. 43 (Wolfgang Zöllner ed., 2nd ed. 1988).

³⁴ However, the company could become a party of the purchase agreement for liability purposes. See Bosch & Gross, *supra* note 32, at no. 10/293.

³⁵ See § 65, KAGG in connection with sections 182 & 186, para. 3, sentences 1-3 *Aktiengesetz* [German Stock Corporation Act], v. 6.9.1965 (BGBl. I S.1089) [hereinafter AktG].

³⁶ BT-Drucks 13/8933, 129 (providing government arguments for § 61, KAGG).

³⁷ KAI-MICHAEL SCHANZ, *BÖRSENEINFÜHRUNG* § 9, no. 40 (2000).

In a normal public stock offering in Germany, a banking syndicate commits itself to subscribe to the shares for its own account and then resells these to the public.³⁸ The subscription and placement obligation arises from an underwriting agreement between the issuer and the syndicated banks.³⁹ The syndicated banks generally subscribe to the new shares at their nominal amount. The difference (additional proceeds or markup) between nominal amount/subscription price⁴⁰ and the subsequent issue price of the floated shares is paid out to the issuer by the syndicated banks due to a contractual obligation in the underwriting agreement.⁴¹ It should be noted that, according to section 9, AktG, paragraph 1, shares may not be issued below their nominal amount or the proportional amount of the registered capital allocable to an individual unit share. This corresponds to the lowest issue price pursuant to section 36a, AktG, paragraph 1. It differs from the collected amount pursuant to section 36, AktG, paragraph 2, which has to amount to at least twenty-five percent of the lowest issue price. According to section 188, AktG, paragraph 2, and section 36, AktG, paragraph 2, a filing for a completed capital increase may only be made after the collected amount has been paid in for each share.

This conventional procedure is only partially useful when floating investment shares. Pursuant to section 63, KAGG, paragraph 1, shares may be issued only against full payment of the issue price. Because of this special statutory provision, no collected

³⁸ Since the shares of an Investment-AG have to be registered for official listing or trading on the regulated market (see § 61, KAGG, para. 3) the cooperation of underwriting managers is compulsory. See § 36, Börsengesetz, para. 2 [German Stock Exchange Act], v. 9.9.1998 (BGBI. I S.2682) [hereinafter BörsG], in connection with § 13, Börsenzulassungsverordnung, para. 1, sentence 5 [German Stock Exchange Admission Regulation], v. 9.9.1998 (BGBI. I S.2832) [hereinafter BörsZulV] and § 71, BörsG, para. 2; see also WOLFGANG GROSS, KAPITALMARKTRECHT, KOMMENTAR ZUM BÖRSG/BÖRSZULV/VERKPROSG/VERKPROSV 120, no. 4 & 214, no. 7 (2000) (stating that an underwriting is mandatory); THOMAS LEDERMANN, in KOMMENTAR ZUM WPHG/BÖRSG/VERKPROSG/BörsG § 71 no. 4 (Frank A. Schäfer ed., 1999).

³⁹ For details, see UTA FREDEBEIL, AKTIENEMISSIONEN 181 (2002); SCHANZ, *supra* note 37, § 9, no. 47; Bosch & Gross, *supra* note 32, at no. 10/294; Gerhard Picot & Volker Land, *Going Public—Typische Rechtsfragen des Ganges an die Börse*, DER BETRIEB 570, 571 (1999); Konstantin Technau, *Rechtsfragen bei der Gestaltung von Übernahmeverträgen ("underwriting agreement") im Zusammenhang mit Aktienemissionen*, DIE AKTIENGESELLSCHAFT, 445, 446 (1998).

⁴⁰ The issue price is the price that the subscribing shareholder promises to pay as contribution. See Karsten Heider, in MÜNCHKOMM/AKTG, § 9, no. 8 (2nd ed. 2000).

⁴¹ SCHANZ, *supra* note 37, § 9, no. 49; Picot & Land, *supra* note 39, at 572.

amount pursuant to section 36, AktG, paragraph 2 comprising only twenty-five percent of the lowest issue price exists, even though section 65, KAGG refers to section 188, AktG, paragraph 2 without restriction. The purpose of the full payment provision is to ensure that the company's assets are fully covered by equity.⁴²

The question arises as to which contribution the syndicated banks, as the first subscribers, have to provide. The above-mentioned lowest issue price pursuant to section 36a, AktG, paragraph 1 cannot be decisive even though section 65, KAGG also refers to section 36a, AktG, paragraph 1 through section 188, AktG, paragraph 2. It is irrelevant whether or not the syndicated banks have to contribute an amount equal to the proportional NAV pursuant to section 63, KAGG, paragraph 2, sentence 2, since they subscribe based on the Investment-AG's public share offer; in this case, the issue price would be determined by section 63, KAGG, paragraph 2, sentence 1.⁴³ As the special provision, section 65, KAGG, no. 2 provides that the issue price⁴⁴ of the shares issued during a capital increase may not be less than the proportional NAV pursuant to section 63, KAGG, paragraph 2, sentence 2. Due to the lack of a reference to section 63, KAGG, paragraph 2, sentence 1, a transaction expense markup is not required. The wording "not be less," however, permits a corresponding markup.

Accordingly, particularities apply during the issuance of new investment shares compared to the conventional underwriting process under the direction of a banking syndicate. The fundraising and the risks involved should be noted. The following case demonstrates this. Assume that an existing stock corporation has net assets of 200 monetary units ("MU"), a registered capital of 100 MU, and the founders hold 100 shares with a nominal value of 1 MU per share. The registered capital is now increased by ninety percent, i.e., 90 MU, and the subscription right is excluded. Now assume that the underwriting banking syndicate subscribes to all the additional shares, which also have a nominal value of 1 MU per share, in order to sell these to the public afterwards at the best possible price. According to the conventional process, the syndicated banks would have to pay only the collected amount of 22.5 MU (twenty-five percent of the lowest issue price, $\Sigma = 90$ MU) after

⁴² BT-Drucks 13/8933, 130 (providing government arguments on § 61, KAGG).

⁴³ See *supra* Section 2.1.1.

⁴⁴ The unofficial heading imprecisely states a "Minimum Price."

subscribing. At the same time, they would commit themselves in the underwriting agreement to pay the corporation any additional proceeds they receive from reselling the shares.

On the other hand, under the special investment provisions, the syndicated banks would need to pay the corporation the full issue price per share, which may not be less than the current NAV per share. This value can be derived by dividing the Investment-AG's net assets (200 MU) by the number of outstanding shares (100). Thus, the syndicated banks have to contribute to the corporation a total of 180 MU (2 MU per share x 90 shares = 180 MU). This example not only illustrates that the underwriting banks have to provide a comparably large amount of capital from the beginning but also that their subscription commitment constitutes an additional hardship if the placement risk materializes, and they are not able to resell all of the shares to the public.⁴⁵

All of this shows how the statutory pricing procedure set forth in section 63, KAGG, paragraph 2, sentence 1 is unnecessary. Taking into account the purpose of the statute, there is no justification for this provision. The overriding purpose of requiring the issue price to be equal to the shares' intrinsic value is already achieved by section 65, KAGG, no. 2. Requiring the underwriting banks to subscribe at a price equal to, at least, the proportional NAV pursuant to the provision does not cause any dilution. Section 63, KAGG, paragraph 2, sentence 1 should no longer be decisive if the underwriting banks intend to resell the investment shares after their fixed acceptance. The wording of this statute relates to the day on which the Investment-AG accepts the public's offers. In reality, the Investment-AG only accepts subscription offers from the underwriting banks. It should also be noted that the term "publicly offered" pursuant to section 63, KAGG, paragraph 2, sentence 1 generally does not conform to the system. Unlike the *Auslandinvestmentgesetz* [German Foreign Investment Company Act] ("*AusInvestmG*")⁴⁶ which does not follow an organizational,

⁴⁵ On the problematic question of reversal, which is not discussed here, see SCHANZ, *supra* note 37, § 9 no. 54; Picot & Land, *supra* note 39, at 573; Technau, *supra* note 39, at 452.

⁴⁶ For information on the differentiation between private placement and public distribution, see § 1, para. 1, § 7, para. 1, § 8, para. 1 *Auslandinvestmentgesetz* [German Foreign Investment Company Act], v. 9.9.1998 (BGB1. I S.2820) [hereinafter *AIG*]; see also KURT PETER DITTRICH, *DIE PRIVATPLAZIERUNG IM DEUTSCHEN KAPITALMARKTRECHT* 35 (1998) (providing references to the corre-

but rather, a capital market law approach,⁴⁷ the differentiation between a public offer and a private placement of investment certificates is irrelevant under the KAGG.⁴⁸ The law does not provide for a private placement of investment shares that is not based on the proportional NAV.

Accordingly, the Investment-AG receives the proceeds from the capital increase-based issue, because the underwriting banks have to subscribe to the Investment-AG's new shares at their proportional NAV. To be on the safe side, a transaction cost markup should be provided. The shares of the original shareholders are therefore not diluted. We believe that the underwriting banks do not have to resell the shares to the public at their proportionate NAV, since section 63, KAGG, paragraph 2, sentence 1 does not apply, based either on its purpose or its wording. Thus, the current legal situation does not prevent market-oriented pricing by the underwriting banks. By taking into account all value-determining factors, which are soon thereafter also discounted by the market price, the market discount phenomenon can be counteracted. Even an intentional "underpricing" is possible.

Admittedly, it is not obvious why an underwriting syndicate that subscribed for investment shares at NAV would intentionally resell the investment shares at a lower price. A typical underwriting manager would pass on a deal like this due to the imminent losses. Preventing the market discount phenomenon would not constitute a sufficient incentive. What we are dealing with in this case is not a typical underwriting transaction where the participating banks generate profits through transaction fees and commissions. Instead, the underwriting is only a means to the end of establishing an Investment-AG according to the statutory requirements, even if it may be a loss-generating activity in the short term.

Experience in the United States shows that profits with closed-end funds are generated not during their creation but only over the long term as management fees.⁴⁹ The investment advisor, who is often a founder of the closed-end fund, constitutes the company's

sponding statement of the BAKred on the public distribution of foreign investment shares); PAUL & PÄSLER, *supra* note 10, introduction no. 133 (same).

⁴⁷ See DITTRICH, *supra* note 46, at 99; Klaus Hopt, *Vom Aktien- und Börsenrecht zum Kapitalmarktrecht?* 141 ZEITSCHRIFT FÜR DAS GESAMTE HANDELSRECHT UND WIRTSCHAFTSRECHT 389, 398 (1977).

⁴⁸ DITTRICH, *supra* note 46, at 100.

⁴⁹ This also applies to open-end funds.

actual management body. After a resale of the shares or a capital increase, the advisor is only linked to the investment company by an advisory contract, which, among other things, regulates the management fees.⁵⁰ The advisory contract has always been at the core of the U.S. Investment Company Act of 1940.

Underwriters will be willing to subscribe to investment shares pursuant to the above-mentioned conditions if they themselves, or one of their subsidiaries, are offered a lucrative long-term advisory contract for managing the portfolio as compensation for the risks and expenses involved in managing the underwriting.

The incentive for a financial intermediary to set up an Investment-AG is the prospect of moving to the position of an investment advisor. Otherwise, management fees cannot be generated over the long term. It is not efficient to set up a portfolio manager for each Investment-AG. Experience shows that centralizing the management of several closed-end funds creates synergies ("externalization of management"). Therefore, closed-end funds in the United States rely on extensive back-office services by third-party investment advisors. The advisors can only secure their long-term influence through a specially drafted advisory contract, because the alternative position as a manager, and therefore representative body of the company, involves too many corporate law imponderables in Germany.⁵¹

It is remarkable that the German legislators did not include a statutory provision concerning the advisory contract. The legislative materials indicate that this traditional core area was overlooked. On one hand, this allows for a lot of leeway when drafting individual advisory agreements with respect to compensation, term, and termination periods. On the other hand, legislators were unable to anticipate the legal consequences, which result from the reference in section 51, KAGG, paragraph 4 to select KWG. According to section 25a, KWG, paragraph 2, the outsourcing to another enterprise of operational areas that is essential for conducting banking business must not impair the orderliness of such busi-

⁵⁰ For details, see STECK, *supra* note 13, at 89, 92.

⁵¹ Only an individual with full legal capacity may be appointed as a member of the management board pursuant to section 76, AktG, paragraph 3, sentence 1. The dispersed composition of the shareholder base may lead to a vote of no confidence and a revocation of the appointment to the management board as a consequence. See § 84, AktG, para. 3; HANS-JOACHIM MERTENS, *in* KÖLNER KOMMENTAR ZUM AKTIENRECHT § 84 no. 43 (2d ed. 1996).

ness.⁵² This statute⁵³ probably limits an economically meaningful outsourcing. If an extreme outsourcing by an Investment-AG is not permitted because of it, the execution of an advisory contract providing comprehensive management services becomes unnecessary. Accordingly, no incentive would exist for a financial intermediary to establish an Investment-AG.

2.2. Permitted Portfolio

Pursuant to section 58, KAGG, paragraph 1, an Investment-AG may invest up to twenty percent of its equity in shares that are not officially listed on a stock exchange or traded on another kind of organized market. It may furthermore acquire silent participations pursuant to section 58, KAGG, paragraph 2, sentence 1, if this kind of investment is permitted by the Investment-AG's articles and the acquisition cost at the time of acquisition together with the book value of silent participations already held by the Investment-AG do not exceed fifty percent of the Investment-AG's equity. Any shares already acquired pursuant to section 58, KAGG, paragraph 1 are to be included in the calculation of this acquisition limit.⁵⁴ As a result, the portion of assets with low liquidity and valuation risks is limited to a maximum of fifty percent of the assets of an Investment-AG.⁵⁵

On one hand, Investment-AGs have greater flexibility in their activities than open-end security funds—§ 8, KAGG—or participation funds—§ 25a, KAGG.⁵⁶ On the other hand, one may disagree

⁵² PAUL & PÄSLER, *supra* note 10, introduction no. 9 (discussing outsourcing of areas of the KAGG business).

⁵³ Introduced by Article 1 of the Act for the Implementation of EU-Directives on the Harmonization of Banking and Securities Law Provisions, v. 22.10.1997 (BGBl. I S.2518) ("6. KWG-Novelle, 01.01.1998"); Theodor Baums & Kai-Uwe Steck, *Bausparkassen als Konzerntöchter*, in WERTPAPIERMITTEILUNG 2261, 2264 (1998); Uwe Eyles, *Funktionsauslagerung (outsourcing) bei Kredit- und Finanzdienstleistungsinstituten*, in WERTPAPIERMITTEILUNG 1217 (2000); Herbert Zerwas & Mathias Hanten, *outsourcing bei Kredit- und Finanzinstituten*, in WERTPAPIERMITTEILUNG 1110 (1998).

⁵⁴ § 58, KAGG, para. 2, sentence 1.

⁵⁵ BAUR, *supra* note 3, § 18, no. 35; cf. PAUL & PÄSLER, *supra* note 10, introduction no. 81 (stating investment restrictions for the assets eligible for the portfolio).

⁵⁶ Pursuant to section 8, KAGG, paragraph 2, only ten percent of the value of a special security pool may be invested in securities that are not registered for official trade on a stock exchange or participate in another organized market. Also, silent participations may be acquired for a special security pool pursuant to section 25b, KAGG, paragraph 3, only to the extent that at the time of their acquisition their value together with the value of the silent participations already held by

on whether or not the investment restrictions for Investment-AGs are too stringent for the creation of funds that function as venture capital or other private equity sources. German venture companies requiring capital are rarely exchange-listed stock corporations. Corresponding to the German corporate landscape, it is mainly limited liability companies ("GmbH") and partnerships that require venture capital.⁵⁷ Conventional participations in such companies are generally excluded as permitted investment objects for Investment-AGs. Investment-AGs may therefore participate in German startups that are structured as a GmbH or partnership only in the form of a silent participation pursuant to section 230 of the *Handelsgesetzbuch* [German Commercial Code] ("HGB").⁵⁸ Accordingly, the catalog of permitted investments needs to be expanded.

2.3. Taxation

2.3.1. Initial Situation

Section 55, KAGG contains no reference to the special tax statutes for open-end investment funds,⁵⁹ so the general tax provisions for stock corporations also apply to Investment-AGs. In particular, the provisions of the KAGG providing tax exemptions for certain distributed profits (i.e., capital gains from the sale of securities, income from the sale of subscription rights for shares in stock corporations, § 40, KAGG) are not applicable to Investment-AGs. In contrast to open-end funds, which are generally exempt from corporate income tax and trade tax pursuant to section 38, KAGG, paragraph 1, only the tax credit procedure applies to Investment-AGs, thus, making them subject to corporate income tax and trade tax, and they need to rely on the tax credit procedures to alleviate these taxes.⁶⁰

the special securities pool does not exceed thirty percent of the value of the special securities pool.

⁵⁷ See generally on venture capital financing Theodor Baums & Matthias Möller, *Venture Capital: US-amerikanisches Modell und deutsches Aktienrecht*, in Festschrift Buxbaum 33 (2000).

⁵⁸ *Handelsgesetzbuch* [German Commercial Code], v. 10.5.1897 (RGBI. S.219), as amended.

⁵⁹ See § 37n, KAGG.

⁶⁰ BAUR, *supra* note 3, § 18, no. 33; PAUL & PÄSLER, *supra* note 10, introduction no. 83. On the credit procedure, see for example, GERRIT FROTSCHER, in *KÖRPERSCHAFTSTEUERGESETZ* [KStG], before § 27, no. 1 (Gerrit Frotscher & Ernst

2.3.2. *Improvements due to the Recent German Tax Reform (UrefSenkG)*

Recently, this initial tax situation, which is considered a major disadvantage of Investment-AGs, changed significantly. The *Unternehmenssteuerreform- und Steuersenkungsgesetz* [Corporate Tax Reform and Tax Reduction Act] ("UrefSenkG")⁶¹ abolished the tax credit procedure. Beginning in 2002, all capital gains, from the sales of shares in incorporated enterprises that are held as operating assets, will not be included when calculating the income of a corporation, association, or asset pool according to the new version of section 8b, paragraph 2, sentence 1 of the *Körperschaftsteuergesetz* [Corporation Tax Act] ("KStG").⁶² While there is a minimum participation requirement, the shares have to be held for at least one year. The tax-free exchange of shares will also generally be possible internationally.⁶³ Consequently, the tax disadvantage-based reservations against Investment-AGs that generate their income mainly by acquiring participations and selling them at a profit will be at least somewhat alleviated by the UrefSenkG.

3. CONCLUSION

From an economic point of view, the Investment-AG's existence is justified as a productive venture capital source with a reliable degree of investor protection. It should therefore be understood as an investment alternative in an efficient and functioning financial market and not as competition for conventional open-end investment companies.

The legal framework for Investment-AGs still leaves much to be desired. In particular, the statutorily prescribed pricing procedure is ambiguous. The legislators took up the traditional idea of

Maas eds., 1999) (describing the tax credit procedures); MANFRED MÖSSNER ET AL., *KÖRPERSCHAFTSTEUERGESETZ* [KStG], § 27, no. 1 (Gerrit Frotscher & Ernst Maas eds., 1999) (same).

⁶¹ Gesetz zur Fortentwicklung des Unternehmensteuerrechts [Corporate Tax Reform and Tax Reduction Act], v. 24.12.2001 (BGBl. I S.3858) [hereinafter UrefSenkG].

⁶² *Körperschaftsteuergesetz* [Corporation Tax Act], v. 22.4.1999 (BGBl. I S.817) [hereinafter KStG]; Ewald Doetsch & Alexander Pung, *Die Änderungen bei der Körperschaftsteuer und bei der Anteilseignebesteuerung*, DER BETRIEB, annex no. 10, 8 (2000); Rainer Heurung et al., *Anwendungs- und Zweifelfragen im Rahmen der Steuerreform*, BETRIEBSBERATER 181, 184 (2001).

⁶³ Hartmut Winkler, *DStZ Aktuell (Gesetzgebung)*, DEUTSCHE STEUER ZEITSCHRIFT 73, 74 (2000).

investment saving, according to which the shares' issue price must correspond with the intrinsic value on the day that the Investment-AG accepts the public's unconditional subscription offers. But currently, during an IPO, a market-oriented pricing procedure and possibly an "underpricing" may become necessary, since it constitutes the only way to avoid the industry-feared investor shock due to the scientifically proven market discount phenomenon. The literal and intentional interpretations of section 63, KAGG, paragraph 2, sentence 1 and section 65, KAGG, no. 2 still permits a market-oriented pricing procedure based on the current law. The underwriting banks, however, have to be willing to subscribe unconditionally and pay an issue price that does not fall short of the Investment-AG's current NAV per share. Furthermore, it should be considered whether or not the hybrid U.S. fund model, which combines the characteristics of the traditional open-end and closed-end funds, should be implemented into German investment law.

When the Investment-AG was included in the KAGG, German legislators did not provide for the so-called "advisory contract." This contract, however, is the basis on which investment advisors may generate any management fees with funds of this kind. The advisory contract is also the only incentive for the underwriting syndicate to establish an Investment-AG while observing all of the particularities of investment law and to take it public.

The investment limits for Investment-AGs set out in the investment laws require some improvement. Due to Germany's corporate landscape, it is mainly GmbHs and partnerships that require venture capital. An Investment-AG, however, may acquire an equity participation in them only in the form of a silent participation pursuant to section 230, HGB.

With respect to taxation, Investment-AGs have always been at a disadvantage to open-end investment funds. UrefSenkG, however, abolishes the tax credit system. As of 2002, German corporations will not be taxed on their capital gains from the sale of shareholdings of other corporations. This leads to a significant improvement of the tax environment for Investment-AGs.

* * * * *