



EU draft directive on alternative investment fund managers

IMPLICATIONS FOR THE REAL ESTATE INDUSTRY

The EU's controversial draft directive on alternative investment fund managers, as currently drafted, has significant implications for the real estate industry; not just for funds and their managers, but potentially also for other real estate-related entities and arrangements that would not conventionally be regarded as funds. This briefing outlines the areas of the directive most likely to affect the real estate industry, including certain aspects on which further clarification would be particularly desirable.

The EU's controversial draft directive on alternative investment fund managers has generated much press coverage and political comment, in particular in relation to its potential effect on the hedge fund and private equity fund industries. But its scope is much broader and has significant implications for the real estate industry; not just for funds and their managers, but potentially also for other real estate-related entities and arrangements that would not conventionally be regarded as funds.

The purpose of the draft directive is to help address vulnerabilities in the global financial system exposed by the current financial crisis. Although the threat that funds pose to global financial stability may be debatable, there is general consensus that increased regulation of funds and their managers operating in the EU or marketing to EU investors is inevitable.

The draft directive's progress through the EU's legislative process is likely to be swift and is now at a critical stage. It is widely acknowledged that the draft directive suffers from ambiguity and a lack of clarity, as well as failing to take account of many characteristics of the businesses that it intends to regulate. With these factors in mind, Paul Myners, financial services secretary to the UK Treasury, has recently called on everyone affected by the draft directive (including funds, their managers, other service providers and, most important, investors) to make their views known in the lobbying process. Investors' views are regarded as especially important because the draft directive has the potential to limit

very significantly the freedom of EU-based investors, including major institutional investors, to invest in funds of their choice, especially funds formed or managed outside the EU.

We have summarised below some of the points on the draft directive as it currently stands likely to be of most interest to the real estate industry, including certain aspects on which further clarification would be particularly desirable.

Scope of the directive

The draft directive contemplates that, subject to some exceptions, persons established in the EU who provide management services to alternative investment funds will be required to be authorised and that authorised managers and the funds they manage will be subject to a number of substantive requirements. Unauthorised persons will not be permitted to provide management services to alternative investment funds or market alternative investment funds in the EU. The draft directive does not, however, impose any direct limitations on investment by funds in real estate located in the EU.

The draft directive's definitions of 'alternative investment fund' and 'management services' may be particularly difficult to apply in the context of the real estate sector. In particular:

- 'alternative investment fund' is defined as 'any collective investment undertaking... whose object

is the collective investment in assets', which, as well as catching almost all fund arrangements (except for UCITS funds, which are expressly excluded), is wide enough to include many entities that would not commonly be considered investment funds. For instance, joint ventures formed for the purpose of acquiring properties may be caught. In addition, the position of self-managed entities under the draft directive is somewhat unclear – it is possible that many self-managed entities, including many listed property companies, could be subject to the directive, especially if they are property investors rather than developers, although it is uncertain who should be the manager of these entities for the purposes of the directive; and

- 'management services' is defined as meaning 'the activities of managing and administering one or more alternative investment funds on behalf of one or more investors'. Although not explicitly stated, this definition seems to be intended to include the provision of advisory, as well as management, services. On its face, the definition could also be taken to include property and facilities management services.

The scope of these definitions is important because they determine which entities are subject to the directive's substantive provisions. Many of these are onerous, may be difficult for real estate funds to implement and would most certainly be problematic if entities that are not commonly regarded as funds are subject to the directive.

The directive's substantive provisions

Although this is by no means an exhaustive list, some of the directive's substantive provisions most relevant to real estate funds, their managers and other entities that may fall within its definition of alternative investment funds are as follows.

- Managers of alternative investment funds must be authorised. A manager of an entity falling within the directive's scope must be authorised by the competent authority of the EU member state in which it has its registered office, subject to some limited exceptions. The exception likely to be of most relevance to many real estate managers is for persons managing alternative investment funds whose assets

under management (including assets acquired through the use of leverage) do not exceed €100m. This threshold is increased to €500m in the case of unleveraged alternative investment funds that do not offer investors redemption rights for a period of five years from launch. However, in determining whether either of these thresholds is met, the assets of funds managed by persons under common management or control or linked by substantive cross-holdings must be aggregated. Therefore, it will not be possible to escape authorisation by forming separate funds with stand-alone managers if those stand-alone managers are part of a group.

- Authorised managers will be subject to minimum capital requirements and conduct of business rules. The minimum capital requirements will be calculated by reference to assets under management. In addition, the draft directive imposes specific conduct of business requirements on authorised managers. This contrasts with the current UK position, under which many property fund advisers are not required to be authorised or subject to specific conduct regulations.
- The ability to delegate will be limited. The delegation of functions by an authorised manager will be subject to some fairly onerous preconditions and will require the pre-approval of the manager's regulator. The manager's liability will not be affected by the delegation. The delegation of functions to non-EU entities may be particularly problematic. A manager will not be permitted to delegate so many of its functions that in essence it can no longer be considered to be the manager of the alternative investment fund. It is relatively common for a manager of a real estate fund or joint venture to be responsible for arranging, but not performing, development activities and to delegate day-to-day asset management to local surveyors – these are activities that have the potential to fall within the directive's restrictions on delegation.
- Each alternative investment fund must appoint an independent valuer. Besides ensuring that yearly valuations take place, the valuer must ensure that the fund's assets are valued each time the fund issues or redeems shares or units.
- Each alternative investment fund must appoint an independent depositary. The depositary will be

required to receive all payments made by investors, safe-keep financial instruments belonging to the fund and verify whether the fund has obtained ownership of all of its other assets. The draft directive currently contemplates that the depositary must be an EU credit institution having its registered office in the EU and will be liable to investors in the fund for losses suffered by them as a result of its failure to perform its obligations.

- The use of leverage will be limited. Managers of alternative investment funds employing high levels of leverage on a systematic basis (defined to mean the combined leverage of the fund from all sources exceeds the equity capital of the fund in two of the past four quarters) will be required to disclose to investors on a quarterly basis (and on a regular basis to its regulator) the amount of leverage employed by the fund. In addition, the draft directive envisages that the European Commission will set limits, yet to be determined, on the maximum level of leverage that alternative investment funds may employ. These limits may vary, taking into account the type of fund, strategy and the sources of leverage. Home member state competent authorities will also have the power to impose additional limits to the level of leverage that may be employed in exceptional circumstances when required to ensure the stability and integrity of the financial system.

Marketing

The benefit of the draft directive much trumpeted by the EU is that it will permit an authorised manager to market a fund throughout the EU. However, unless particular member states agree otherwise, marketing will be permitted only to professional investors (which excludes most individual and retail investors). There is also some confusion over who is permitted to market funds managed by authorised managers and funds' ability to use placement agents may be affected. Further, the draft directive currently provides that a fund may be marketed only with the pre-clearance of the relevant home member state regulator, which may take up to 10 working days to obtain. Interests in funds that are not managed by an authorised manager will not be permitted to be sold on the basis of 'reverse enquiries', in which a

potential investor contacts the fund or its manager on an unsolicited basis.

Application to existing arrangements

The draft directive contemplates that existing managers of alternative investment funds must take all necessary measures to comply with the directive and submit an application for authorisation within one year of the deadline for the implementation of the directive into the national law of member states. Although the draft directive is silent on the point, implicit in this is presumably a one-year timeline to restructure existing funds to comply with the directive's substantive requirements. The position for existing non-EU funds with non-EU managers that have EU investors is unclear.

Application to offshore and other non-EU arrangements

One of the most controversial aspects of the draft directive is its treatment of managers and funds from outside the EU. Offshore structures are very commonly used for real estate investment but the draft directive imposes considerable restrictions on their use. In particular:

- alternative investment funds domiciled in third countries may be marketed in a member state only if the relevant third country has signed an Organisation for Economic Co-operation and Development-compliant tax information exchange agreement with that member state;
- managers established in a third country may market shares or units in an alternative investment fund to professional investors in the EU only if a member state determines that the third country has satisfied a number of pre-conditions, including over the standard of regulation in the third country and the access granted by the third country to EU fund managers; and
- the ability of a manager, depositary and valuer to delegate to a service provider in a third country are subject to some stringent pre-conditions, including over the equivalence of the third country's legislative and regulatory regime.

The provisions regarding non-EU managers and funds come into effect three years after the start of the rest of the directive and, until then, the position for non-EU managers and funds remains as determined under the national law of member states. There is considerable uncertainty about how existing non-EU structures that have existing EU-resident investors will be treated under the new regime, especially if they do not intend to raise any new money from within the EU.

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