EUROPEAN PUBLIC
REAL ESTATE ASSOCIATION

23 March 2012

ESMA Discussion Paper

Key concepts of the Alternative Investment Fund Managers Directive and types of AIFM (ESMA/2012/117)

Comments submitted electronically to the ESMA consultation website on 23 March 2012.

Introduction

The European Public Real Estate Association (EPRA) is the voice of the European publicly traded property sector. EPRA represents publicly listed property companies who own, manage, acquire, sell, develop, refurbish, and operate commercial property. Our membership also includes the investment institutions who invest in the sector and the firms and individuals who advise and service those businesses. The institutional investors within EPRA's membership include the largest pension funds in Europe with a long track record of investment into the property sector. Between them our 200 members represent over €250bn of commercial property. Since its establishment in 1999, EPRA have been representing the European listed property sector in its discussions with those bodies that are responsible for the regulatory framework within which the sector operates, including the European Commission, ESMA, EIOPA, the International Accounting Standards Board, the OECD, and national governments and regulators.

Executive Summary

EPRA's view is that the concepts discussed in the ESMA Discussion Paper (DP) provide a good platform for developing a sensible European-wide interpretation of the AIFMD ("the Directive"). The AIF definition is deliberately broad as evidenced by the fact that there is, as yet, no identifiable corporate business that has been confirmed as <u>not</u> meeting the AIF definition, save for specific provisions in the Directive[1]. Accordingly, the development of guidance to appropriately identify funds within a range of different business models, strategies, asset classes and structures across Europe and globally is an extremely challenging but critical exercise. This is particularly important for corporate businesses in the listed commercial property sector, which are regulated in the same way as any other listed company, who are not funds and whereby both themselves and their shareholders receive no identifiable benefit from being within the scope of the Directive.

[1] For example, the Directive states that it will not apply to certain pension and supranational institutions, national central banks, governmental bodies, employee participation or savings schemes, securitisation and special purpose entities as well as certain holding companies and joint ventures.

It is our strong view that the clearest path to appropriately identifying the type of European and global businesses that are the intended target of the Directive is to focus on the unique relationship that a fund has with its investors, compared with that of a non-fund. For this reason, we support ESMA's focus on the development of further criteria to determine whether a particular business has a "defined investment policy". We also fully support ESMA's position as stated in the DP that "concentrating on the asset classes of AIFs or the investment strategies applied to those asset classes is not the correct approach". We believe that attempting to apply the Directive by identifying specific asset classes or businesses strategies would result in an inconsistent and inappropriate application and be contrary to our understanding of the Directives intended purpose.

General Comments

We recognise that, in the light of the diverse nature of the real estate sector, distinguishing between entities that should be regarded as AIF/AIFM, and those which should not, is not always easy. Indeed, there may well be grey areas with hybrid organisations/businesses where classification is very difficult. However, we think the distinction does need to be drawn: the Directive should apply to fund management businesses in the real estate sector, but should have no application at all to proprietary business carried on outside the fund management context (as managers and investors would recognise it). We believe that national regulators should not find it difficult to reach that conclusion. In this respect, we would discourage ESMA from placing too much emphasis on a "Q&A type" approach to developing guidance as suggested in para 3 of the DP. In our experience this does not lend itself to effective process for application of the Directive.

In our discussions with regulators it is clear that the use of labels such as 'REITs' to collectively describe listed property companies (which are clearly not "investment trusts", as the name might otherwise imply) such as SIICs (France), SICAFIs (Belgium), FBIs (Netherlands) and G-REITs (Germany) are confusing and unhelpful as a term may be used in different jurisdictions with different meanings.

We believe that the criteria for identifying AIFs and AIFMs outlined in the ESMA DP should help to ensure a consistent and harmonised application of the Directive and are generally supportive of the approach taken. We have provided specific comments with respect to how this could be developed further below. Where relevant and helpful in the context of supporting ESMA's position or enhancing understanding of its practical application, we have also applied the criteria discussed to companies in the European listed property sector.

IV. Definition of AIF
Question 2. Do you see merit in clarifying the terms 'insurance contracts' and 'joint ventures'? If yes, please provide suggestions.
We do see merit in clarifying the term "joint ventures", and set out our suggestions below. Joint ventures are a very important means by which listed and unlisted property companies manage the risk and complexities involved in the major property development/redevelopment activities which are capital intensive and typically involve long term commitments as well as requirements for specific expertise. A joint venture in the real estate context will normally involve a small number of participants (two is common) agreeing to develop or manage an asset or a portfolio of assets for their mutual profit. Even in cases where each participant is itself an active property development or investment

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business, they will not generally all participate in the day-to-day management of the joint venture undertaking. For example, in order to share risk and market expertise, two specialist shopping centre investors may form a joint venture to manage a large shopping centre, but it will often only be one of those investors which take responsibility for the day-to-day management of the centre. Indeed, as day-to-day management of a mature, income-producing property may largely relate to property management, that activity may be outsourced altogether.

The characteristic feature of a joint venture is that each participant in the joint venture undertaking will have a contractual right to participate in, and will in fact actively participate in, the key strategic decisions relating to the undertaking. That contrasts with the position in the context of an AIF, where the AIFM would have broad discretions in managing the AIF, within the bounds set by the AIF's defined investment policy, without needing to secure the agreement of its investors to particular actions. AIF investors do not generally expect to retain active involvement in decisions about the management of the AIF, whereas it is typically very important to joint venture participants to be involved in key decisions.

The key decisions in which property joint venture participants would be involved are often referred to as "reserved matters" or matters subject to explicit consent of the partners in the constitutional documents of the joint venture, and while they will vary from joint venture to joint venture, they may include:

- The acquisition or disposal of a property by the joint venture;
- Decisions to carry out development requiring capital expenditure;
- The raising by the joint venture of debt finance and changes to its overall gearing level;
- Matters relating to the tenant mix within a commercial property, including granting new leases or varying existing leases;
- Capital distributions by the joint venture to its participants and issues of shares or other interests by the joint venture to any party;
- Appointment of professional advisors (including auditors).

While a joint venture will always have at least two participants, it will often have not much more than two participants, and the private, bespoke, negotiated nature of a joint venture arrangement means that capital cannot be said to be raised from the public and should perhaps not be considered even to be raised from a number of investors. However, we believe that the more robust distinction between AIFs and joint ventures is the way participants in a joint venture will retain control over important decisions throughout the life of the undertaking, rather than allowing a manager the discretion to manage the undertaking as it wishes within the bounds of a defined investment policy. The joint venture partners are negotiating all the terms with open outcome, they are not being offered a subscription to review and accept essentially as it is being offered.

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<u>Question 3.</u> Do you see merit in elaborating further on the characteristics of holding companies, based on the definition provided by Article 4(1)(o) of the AIFMD? If yes, please provide suggestions.

As a general comment, it is not clear to us how the holding company exemption is intended to apply. However, notwithstanding the comments below, if the holding company exemption is intended to take normal operating businesses with business strategies out of scope then we would recommend that this is clarified. However, as a point of principle, we believe it is more important to better understand and clarify how the basic definition of an AIF applies in the context of normal operating business that are not funds.

We note that the "holding company" definition is set out in clear and specific terms in Article 4(1)(o), and that Article 3(a) very clearly states that the Directive shall not apply to holding companies. We acknowledge that the first three sentences of Recital 8 seem to suggest that the "holding company" definition should be construed more narrowly than its terms might suggest. However, it cannot be right to say, as para 16 does, that "the explicit exclusion of holding companies should not be used as a means to circumvent the provisions of the Directive. Articles 3(a) and 4(1)(o) are themselves provisions of the Directive. A failure to give them adequate effect would, therefore, itself circumvent the provisions of the Directive. It may be helpful for ESMA to consider giving some guidance as to what Articles 3(a) and 4(1)(o) are intended to achieve and how they should be construed.

<u>Question 4.</u> Do you see merit in clarifying further the notion of any of the other exclusions and exemptions mentioned above in this section? If yes, please explain which other exclusions and exemptions should be further clarified and provide suggestions.

From a property company perspective, we do not believe that further clarification of the other exclusions and exemptions are required. As discussed above, clarification of how the Directive applies to normal operating businesses is most important aspect that needs to be clarified for ensuring businesses that are not funds are not caught within the scope of the Directive.

<u>Question 5.</u> Do you agree with the orientations set out above on the content of the criteria extracted from the definition of the AIF?

In broad terms, we agree with the orientations set out in section 4 of the paper, but we have a number of specific observations on paras 24 to 34. We have set out in our response to this question our comments on points not specifically covered by other questions.

<u>Raise capital</u>

We broadly agree with the comments in para 25-27 but consider that further helpful criteria may be developed around identifying the types of capital raising that a normal company undertakes versus that which a fund more typically takes, including the fact that a shareholder in a company will typically buy or sell shares through the secondary markets rather than through specific company issuances. Raising capital for a fund as a criterion should be understood to be an activity which is

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focusing on offering a prepared participation in return for investor's money.

Collective Undertakings

From a property company perspective, we agree with para 28.

In the context of European listed property companies, we do not think they would be regarded as "collective investment undertakings" (and therefore AIFs). Unlike fund managers which manage a close investor relationship, listed property companies, just like other listed company have a more distant relationship with their investor, who will typically not have contact with the company and whose identity will generally be unknown. Investors, as shareholders, receive dividends from income generated but are not involved in business strategy in any way. Investors will typically purchase or sell their shares in the secondary markets and capital raising is generally infrequent and for general corporate strategy rather than investment specific. As with other corporate businesses, listed property companies place great importance on their customer (tenant, visitor) as well as investor relationships, whereas a fund will have a more investor focused approach. Collective investors are relying on the same bond, the individual offering document or prospectus or subscription terms according to which the manager is strictly bound to adhere to.

Defined investment policy

We believe that it is the right approach to determine whether a defined investment policy exists by considering a number of factors and we broadly agree with the indicative criteria set out in para 31 for determining whether or not an entity has a defined investment policy.

In this respect, we anticipate that the listed property companies would not be construed as raising "capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors". A listed property company's obligations to its shareholders are no different to that of any other publicly listed company, including acting for its own account. We are therefore broadly supportive of the indicative criteria proposed by ESMA which should provide the core criteria for ensuring that the broader corporate commercial sector are not brought within the scope of the Directive.

However, we have some concerns that the defined investment policy is potentially too broad. In essence it could be considered that any normal company bylaw is a defined investment policy with the definition is the ESMA document.

We do hold the view that the use of a defined investment policy is different and more specific for funds than the strategy of a company with general commercial purposes. The latter has a "business strategy" albeit that it will inevitably involve investment of some form. It can be revised or reviewed without shareholder involvement. A defined investment policy can be identified as being more specific and prescribed in relation to how investors' money can be used or invested than simply investing in the assets or working capital for the commercial objectives of the business.

One potential identifier of a defined investment policy to which we would disagree is the point set out in para. 31 that states, "the investment policy is clearly set out and disclosed to investors" – as this may easily blur the line between a business strategy, which can often be clearly disclosed to investors in company prospectuses, websites, other company marketing materials (investment-related or otherwise), or shareholder communications. Furthermore, given the defined investment policy is part of the contractual agreement between an investor and a fund, this additional criterion is superfluous to the overall description of a defined investment policy in the DP and, as such, could

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confuse the application of what we see as a well-reasoned and clear set of criteria.

European property companies with 'REIT' status

In applying this concept in the context of European listed property companies there is potential for confusion where the national tax legislation imposes certain taxation related conditions in order for a certain beneficial tax treatment to apply to property related (e.g. leverage limits, trading activity, minimum distribution requirements risk management, etc.).

REIT status is not typically part of the shareholder relationship for a REIT of itself (albeit a reason why a shareholder may wish to invest and a matter the board of directors may wish to have) and shareholder consent is not a REIT requirement. Many other businesses in various jurisdictions have tax laws, whereby specific conditions must be met in order to receive a particular tax treatment for income and expenses of the business. These are business considerations for their management and REIT status should be regarded in a similar fashion.

The potential for confusion with respect to various 'REIT' taxation conditions and the interpretation of a defined investment policy may also extend to other types of taxation regimes in other sector. We recommend that ESMA makes it clear that a restriction imposed by legislation in order to obtain certain taxation benefit should not be considered as a defined investment policy (i.e. a restriction imposed by law to a company that chooses to benefit from the REIT regime should not be considered as an investment policy). This would be for instance when the company could operate under another regime, but chooses to accept certain conditions in order to get a benefit. For example, the Board of Directors of a German or UK REIT could operate as a normal property company, but chooses to elect to REIT status to benefit from the tax shield, in contrast to a German open-ended fund that cannot operate outside the scope of the German Investment act.

A particular taxation status can change either due to the deliberate actions of management, accidentally or in error. The result is that it does more or less the same business but in that fiscal year is treated as a regular taxable company. The management of a REIT can make decision whether it makes sense to continue to retain the tax status based on their individual, potentially frequently changed, market strategy. With a fund defined investment criteria must not be abandoned.

The important feature of a defined investment policy that distinguishes it from a business strategy or investment strategy is that it is defined, i.e., fixed, and cannot be changed or ignored by the AIFM unless typically all investors agree and /or the national regulator also agrees. The management of an ordinary company, by contrast, can periodically review and revise its strategy with or without the involvement of the company's shareholders.

Question 6. Do you have any alternative/additional suggestions on the content of these criteria?

Only as set out in response to Question 5 above and Questions 7 to 10 below.

Question 10. Do you agree with the analysis on the absence of any investor discretion or control of the underlying assets in an AIF? If not, please explain why.

We do not disagree with what is said in para 34, but we believe that the more important point to

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focus on is not whether investors have “day-to-day” discretion or control over the AIF’s assets (they would plainly never have that), but rather on whether they can and do participate in the making of key, strategic decisions relating to the management of the AIF.

As mentioned above in the response to Question 2, a key characteristic of a joint venture in the real estate context is that the joint venture participants will agree certain matters that are so important that one party acting alone cannot decide them, even if that party has sole or primary day-to-day management of the joint venture. In an AIF, on the other hand, the defined investment policy would typically allow the AIFM sufficient discretion and authority to make all important decisions without having to secure the agreement of investors.

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