

Real Estate

The proposed EU Directive on Alternative Investment Fund Managers (AIFM) could have far reaching effects for Real Estate Funds

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Key points to note are:

- The aim of the directive is to establish a comprehensive and effective regulatory and supervisory framework for all EU managed Alternative Investment Funds (AIF), which includes Real Estate funds, with very limited exemptions.
- The obligations imposed on the AIFM by the draft directive may require significant changes to be made to the AIFM's current business model.

Background

The EU's proposed draft directive (Directive) on Alternative Investment Fund Managers (AIFM) could radically reshape the alternative asset management industry in some EU countries, potentially requiring changes to AIFMs' business models and significantly increasing the regulatory burdens on alternative investment funds (AIF). The Directive also poses serious questions on the accessibility of the EU's markets to non-EU alternative fund managers and funds and how EU based managers with funds or connections outside the EU are going to be able to continue to operate.

If enacted in its current form, the Directive will impose a comprehensive regulatory regime on the managers of all collective investment vehicles which are not qualifying UCITs, whether open or closed ended and whether or not listed, subject to a few minor exclusions. This could significantly increase the costs faced by real estate fund managers.

Who is caught?

The Directive catches the managers of real estate funds as well as REITs, listed investment trusts and other forms of collective investment vehicle which have previously been outside the scope of financial services regulation.

However, AIFM that are either divisions of EU banks or insurers, authorised pension fund managers and various categories of sovereign wealth funds are excluded from the scope of the Directive, potentially putting those institutions at a relative competitive advantage.

The Directive will apply to all AIFM with assets under management in excess of €100m. It is unclear if this is net or gross assets but does include assets "acquired through the use of leverage". This limit is cumulative i.e. applies to the total of all funds managed by and AIFM and is not on a per fund basis.

Non EU AIFM

Fund managers established outside the EU will need to seek authorisation from a Member State in order to market shares or units in any AIF in the EU, subject to meeting certain stringent conditions which have been approved by the EU Commission. These conditions relate to prudential regulatory capital, systems and controls, risk management and reporting requirements. Furthermore, the AIFM's home country must agree to comply with OECD standards on exchange of tax information (see 'Core requirements' below). The Member State applied to will not be involved in the authorisation decision-making process. In addition, qualifying AIFM will need to appoint EU resident custodians (or "depositories" as named under the Directive), independent valuers and EU qualifying auditors. A key concern flowing from the authorisation process is that (non-EU domiciled) offshore real estate AIFM cannot receive delegated portfolio and risk management functions since these can only be delegated to AIFM authorised under the Directive to manage a fund of the same type.

With regard to the more immediate future, non-EU based AIFM licensed to market AIFs domiciled outside the EU to professional investors based within an EU Member State will only become available three years after the Directive comes into force and until that time, an AIFM established outside the EU may continue to market a non-EU domiciled AIF under existing private placement laws currently in force in the relevant Member State.

Core requirements of the draft Directive

All AIFM which are caught by the Directive will need to be regulated by their "home state" financial regulator. The authorisation process will require submission of detailed information to the regulator about managers and controllers, about the AIFs to be managed (strategies and constitution), the countries where the AIFs are to be sold and details of the custodians, valuers and other third parties to whom material functions are delegated.

All AIFM which become regulated will need to meet the following requirements (amongst others):

- Documented internal systems of management and control complying with EU standards (as yet unspecified) relating to liquidity, management of conflicts of interest, risk management (including appropriate "documented and regularly updated due diligence when investing") and short selling;
- An independent "valuator", who must value assets in the AIF on at least a yearly basis, in accordance with local GAAP or in accordance with rules set out in the AIF's constitution;
- An independent depository (which must be an EU authorised credit institution), whose function will be to receive investor subscriptions, safe keep financial assets and to verify the AIF has ownership of assets it has invested in.

All AIFM will be required to disclose to their regulators details (yet to be specified) of the principal markets and investments in which they trade (including, on an aggregated basis, details of their principal exposures and concentrations) and details of their leverage through quarterly reporting. The Directive contains unusual provisions specifying that the Commission (rather than a home state regulator) can impose caps on the amount of leverage a AIFM can employ. The home member state of an AIFM can impose additional limits on leverage, in exceptional circumstances if required to maintain financial system stability.

All AIFM will be required to produce detailed information for prospective investors and, to the extent they use leverage on a systematic basis, detailed information on that usage on a quarterly basis.

Participations in AIF managed by AIFM which are authorised may be sold only to professional investors (as defined in MiFID). Initially AIF may be marketed to professional investors in the AIFM's home member state but may, subject to complying with passporting requirements be sold to professional investors in other member states.

Although the Directive establishes clear procedures for marketing AIFs domiciled in the EU, the ability of an AIFM to market AIF which are domiciled outside the EU (e.g. in Jersey or Cayman) will be subject to detailed restrictions, including a requirement that the AIF's jurisdiction has signed an agreement to share tax information which complies fully with the OECD standards with the jurisdiction into which the AIF is to be marketed. This passport will not be available for three years, and prior thereto, non-EU domiciled AIF may only be marketed into those EU states where they can currently be sold under domestic law.

Possible impact on the real estate industry

- Currently the real estate fund regulatory regime around Europe is broadly divided between relatively lightly regulated partnership regimes (e.g. the UK) and more heavily regulated regimes e.g. in Germany, Luxemburg and France. Investors have a choice as to what is most appropriate for them. The new regime will result in all AIFM being heavily regulated with significant increased costs;
- The Directive could accelerate a consolidation in the European fund management industry with the burden of regulation making the cost / benefits of managing smaller funds uneconomic;
- There does not appear to be level playing field with sovereign wealth funds, EU registered banks, pension funds and insurance companies potentially enjoying a carve out from the Directive which could give them an advantage over private equity real estate fund managers.

Timetable – the time to act is now

If political approval on the Commission's proposals is reached by the end of 2009, the Directive could come into force in 2011. Given the proposed reach of the Directive, potentially affected businesses need to assess the potential impact of the Directive immediately, so that they can seek to influence the shape of the final Directive and its implementing regulations, and, to the extent necessary, start planning for the changes the Directive will require.

PwC are working actively with clients, as well as the regulators and industry bodies, to assist them in assessing the impact of these proposed changes on individual business and the alternatives sector generally.

Summary

If the draft Directive is finalised in its current form it will have far reaching implications for the industry in terms of the way in which both fund management business and funds are structured.

The reporting and other obligations imposed by the draft Directive will require in many cases:

- Systems changes
- Changes to the business model. For example funds may not have a depositary or an independent valuer
- An acceleration of the audit timetable to produce audited accounts within four months
- Additional regulatory capital
- If non-EU domiciles do not sign up to the information sharing framework with the EU, an EU based AIFM will not be able to manage funds domiciled in such countries.

Given the stated intention is to introduce the Directive in 2011 this gives fund managers a relatively short period of time to implement the changes required to their systems and business model.

You therefore need to assess the potential impact of the Directive on your business as a priority.

Who to contact

If you would like to discuss any of the above issues please do not hesitate to contact your usual PricewaterhouseCoopers contact or one of the specialists listed below:

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