



The Association of Real Estate Funds

European Securities and Markets Authority  
11-13 avenue de Friedland  
75008 Paris  
FRANCE

14 January 2011

Dear Sir

**CALL FOR EVIDENCE: Implementing measures on the Alternative Investment Fund Managers Directive (“the Directive”).**

The Association of Real Estate Funds (“AREF”) represents the UK unlisted real estate funds industry and has 70 member funds with a collective net asset value of about €35 billion. Member funds take the form of authorised retail funds and various specialised structures, both open-ended and closed-ended, based in the UK and offshore, aimed at pension schemes, charities and other professional investors. The Association is committed to promoting transparency, consistency and comparability between funds and maintains a Code of Practice defining the industry standards that the Association expects its members to uphold.

In answering the call for evidence we are aware of a number of other association’s submissions. Our submission focuses on the issues that distinguish real estate AIFM from managers of other types of AIF. In particular we have responded in more detail to the issues relating to valuation and liquidity management because the nature of the real estate asset class gives rise to significant differences in these areas compared to AIF invested in financial instruments. However, this should not be interpreted as diminishing the importance of other aspects that are covered in more detail by others.

There are a number of general points we would like to draw your attention to:

- The range of types of AIF whose managers will be required to become authorised under the Directive is enormous. The amount of existing legislation with which those AIFM are already required to comply is extensive, both at European and national level. In formulating its recommendations ESMA should ensure the legislative framework is consistent (for example with MiFID or UCITS) and proportional (for example, recognising the appropriate level of protection for professional investors is not the same as for retail investors) both in its requirements and its level of detail.
- The high level of diversity in types of AIF and existing national practices means there is a high risk from unintended consequences as the level 2 measures are developed. It is therefore essential that this call for evidence is the first step in an ongoing and comprehensive dialogue in order to ensure that such adverse consequences can be identified and resolved.

- It took 18 months to reach a satisfactory compromise concerning the Directive. The process involved significant changes to some of the level 1 provisions and inevitably in areas where compromise was not reached the Directive made provisions for level 2 rules. It is essential that in developing recommendations concerning level 2 measures ESMA is blind to the measures that did not form part of the final compromise and makes recommendations based solely on the final text of the Directive and the opinions offered in response to this call for evidence.

Finally we would welcome the opportunity to clarify or expand on the points we have raised in this response.

Yours faithfully

A handwritten signature in black ink, appearing to read 'M Sherwin', with a stylized, cursive script.

Mark Sherwin  
Secretary General

## **Additional questions for the call for evidence**

- 1. Which categories of investment manager and investment fund will fall within the scope of the Alternative Investment Fund Managers in your jurisdiction? Please provide a brief description of the main characteristics of these entities (investment strategies pursued, underlying assets, use of leverage, redemption policy etc).**

The Directive has been drafted to ensure as wide a scope as possible. However, the scope of this response to the call for evidence is unlisted real estate funds, that is AIF that invest mainly in physical real estate assets (land and buildings) directly or via other collective investment undertakings. The shares or units of these AIF are not listed, and cannot be traded, on any formal stock market.

The investment strategies that distinguish groups of real estate funds are the sectors in which they invest (warehouses, shopping centres, offices, etc) and the extent to which they are involved in real estate development or just leasing finished buildings. This response does not consider the other real estate interests such as funds that use derivatives to create synthetic real estate exposures.

Some funds use leverage in the form of long term borrowing secured on the real estate assets. This is particularly common with closed-ended funds. Because of the nature of real estate assets, open-ended funds have flexible redemption policies that often allow ready access to redemptions when markets are healthy but also allow managers to restrict, defer or suspend redemptions in more extreme markets.

- 2. Among the topics that will be covered by the implementing measures, which do you consider would be most appropriately adopted in the form of regulations or directives? Please explain your choice.**

Directives are most likely to be appropriate for addressing the issues that place obligations on AIFM in order that Competent Authorities can tailor the rules to the specificities of their own Member State. Regulations are better suited to the enabling provisions in order to ensure a level playing field. There is great diversity in the types of AIF managed by the AIFM that will be required to become authorised and it is therefore appropriate in most instances to use Directives to set higher level principles that can be refined at national level in order to accommodate this diversity. However, the Commission needs to safeguard the passport and therefore Regulations would be appropriate where the requirements related to the passport, for example the transparency requirements in Chapter IV of the Directive.

## **Part I: General provisions, authorisation and operating conditions**

### **Issue 1 – Article 3 Exemptions**

#### **Issue 1 a) – Opt-in procedure for AIFM below the threshold**

We see no reason for the authorisation procedure for AIFM that choose to opt-in to be any different to that for AIFM that are required to apply for authorisation.

Third country AIFM will not be able to apply for authorisation for a further two years after the final transposition date so the question of determining the Member State of reference should be considered at a later date.

### **Issue 1 b) – Thresholds – calculation, oscillation, obligations below thresholds**

The most reliable source of information regarding an AIFM's assets under management is likely to be the audited annual report for each AIF that it manages. Where the total assets oscillates around the threshold, one possible approach to assessing the need to apply for authorisation could be based on expectations for significant growth in assets under management as a result of new investment. Investment returns alone should not trigger the need to apply for authorisation.

The purpose of the threshold is proportionality - it ensures small AIFM whose size alone means they do not pose significant systemic risk are not overly burdened with the costs of complying with the Directive. With this in mind it would be appropriate to defer work in this area until regulators are able to see the types of AIFM that fall below the threshold and the extent to which they take advantage of the exemption.

### **Issue 2 – Article 9 Initial capital and own funds**

An approach consistent with the Insurance Mediation Directive should be adopted in respect of the requirements for professional indemnity insurance.

### **Issue 3 - Article 12 General principles**

An appropriate level of consistency with the relevant provisions of MiFID and UCITS (obligations regarding management companies) is desirable.

### **Issue 4 - Article 14 Conflicts of interest**

An appropriate level of consistency with the relevant provisions of MiFID and UCITS (obligations regarding management companies) is desirable.

### **Issue 5 – Article 15 Risk management**

An appropriate level of consistency with the relevant provisions of MiFID and UCITS (obligations regarding management companies) is desirable.

### **Issue 6 - Article 16 Liquidity management**

Managers of open-ended real estate funds are familiar with the challenges of liquidity management. Real estate transactions typically take 3 to 6 months to execute and in difficult markets, such as during the financial crisis, it may take several months to find a buyer for a particular asset. Investors use open-ended real estate funds in order to gain exposure to real estate and so will not welcome an investment return that is diluted by persistently large cash balances. With such an inflexible liquidity profile for real estate investments, Managers must ensure there is sufficient flexibility in their redemption policies and valuation policies to enable them to meet their underlying obligations in a way that is fair to investors.

In normal conditions Managers will be able to monitor and forecast inflows and outflows from investors and manage their investment transactions accordingly. It would be inappropriate to place restrictions on the redemption policies in these circumstances.

In exceptional conditions Managers will need to have measures at their disposal to ensure the timing and price attributed to redemptions is fair to both the continuing and the redeeming investors. In periods of high redemptions Managers need to ensure that continuing investors do not suffer as a result of meeting the redemption obligation. This can be achieved by deferring redemptions until sufficient assets can be sold or by ensuring that, where assets are sold quickly in an adverse market, the discount is fully reflected in the price of shares or units. The valuation policy is discussed further in relation to issue 9.

It is not clear what *“the alignment of the investment strategy, liquidity profile and redemption policy”* means. In the case of a real estate it is likely that the investment strategy is something like “to invest the capital raised in real estate assets in order to generate a return.” Therefore it is not a question of aligning the investment strategy and the liquidity profile; the liquidity profile is the result of the strategy to invest in real estate.

However, it is essential that the redemption policies are aligned with the liquidity profile so that an open-ended real estate fund can meet its underlying obligations under both normal and exceptional liquidity conditions. In reality the redemption policies will include a range of mechanisms, such as notice periods, deferrals, gates and suspension that can be invoked in exceptional circumstances.

## **Issue 8 – Section 2 Organisational requirements, Article 18 General principles**

An appropriate level of consistency with the relevant provisions of MiFID and UCITS (obligations regarding management companies) is desirable.

## **Issue 9 - Article 19 Valuation**

It is essential that ESMA focuses its advice on the criteria for determining that appropriate procedures are in place rather than on the procedures themselves. Different Member States have evolved different practices and different solutions to problems. It would be wrong to determine that one is more appropriate than another and the focus should be on transparency rather than method.

The directive reflects that there are two clear and distinct aspects to valuation: “valuation of the assets” and the “calculation of the net asset value per share or unit”. In the case of a real estate fund it is necessary to understand that there is unlikely to be a single valuer that can perform both aspects. In particular, the valuation of real estate assets requires a highly specialised valuer with extensive knowledge of the asset in question, its location, its current or potential use and the purpose for which the valuation is to be used. Where a real estate fund invests in a number of jurisdictions it is likely that a different valuer will be appointed in each jurisdiction.

### *Valuation of real estate assets*

Unlike other asset classes, real estate assets are not homogeneous and considerable rigor must be applied to estimating their value. There are two approaches to valuing real estate and each method is used to validate the other. The result of the valuation process is an estimate valid for a specific set of assumptions and conditions.

The first approach is to value the asset based upon an actual or estimated cash flow that is, or could be, generated in the form of rent. The income stream identified is

then used to estimate the value using a discounted cash flow model to determine the net present value of the future cash flows. The discount rate will be derived from observation of the returns implicit in the price paid for real estate traded in the open market. The appropriate discount rate should be determined from analysis of the yields implicit in transactions in the market for similar interests in similar real estate. Where this is not possible, an appropriate discount rate may be built up from a typical "risk free" rate of return and adjusted for the additional risks and opportunities specific to the particular real estate interest in question.

The second approach is to compare the subject of the valuation with the price of other real estate that has been recently exchanged or that may be currently available in the market. It is usual to adopt a suitable unit of comparison such as the price per square metre of a building. The weight that can be applied to a unit of comparison in the valuation process must be determined by comparing various characteristics of the real estate providing the price information with the real estate being valued. These characteristics will include considering any differences between the real estate interests in question, the respective locations, age, quality, or specifications, the permitted use or zoning of each, the circumstances under which the price was determined and the basis of valuation required and the effective date of the price evidence and the required valuation date.

In the case of partially completed real estate, the valuation will be determined by estimating the value when complete using the methods described above and deducting the costs required for completion and adjustments for profit and risk.

Where valuations are prepared for use by open-ended real estate funds the basis of the valuation required is particularly relevant. For example, the length of the marketing period is a key assumption when valuing real estate. Where it is known that a fund must sell real estate quickly in order to settle redemptions it might be appropriate to assume a shorter marketing period than would otherwise be the case and therefore to accept a lower valuation.

The International Valuation Standards Council (IVSC) sets principles for good valuation practice for real estate and other types of assets. The IVSC is in the process of updating and improving its International Valuation Standards which are expected to be published in April 2011.

#### *Calculation of the net asset value per share or unit*

The calculation for real estate funds is in principle no different to other types of fund. Once the portfolio of assets has been valued, and other accounting records updated for income, fees and so on the net asset value can be calculated.

#### *Professional guarantees*

The valuer of real estate assets is normally required to be fully independent and in the terms of the Directive will be an external valuer. It is likely that the impact of guarantees will be that investors will suffer the effect of higher costs for the services of external valuers. It is less likely that there will be a significant reduction in the availability of external valuers.

For real estate assets a valuation is more than a number, it is a report on a set of circumstances, assumptions and explanations. It might comment on areas of valuation uncertainty that may arise as a result of, for example, market instability.

Valuers need to be able to provide a full report on such matters without being constrained by guarantees. Excessive guarantees pose the risk that valuers will cut back on the content of their reports.

#### *Frequency of valuation*

It is not uncommon for real estate funds to issue and redeem shares or units more frequently than the real estate valuations are performed. For example, real estate funds structured as UCITS equivalent funds and suitable for retail investors often allow daily issuance and redemption but the real estate valuation is rarely performed more frequently than monthly. It is generally the case that more frequent valuation assessments would not provide any meaningful improvement in the accuracy of the valuation.

Concentrating on a valuation frequency appropriate to redemption frequency fails to take account of other key factors. It is the method and assumptions inherent in a valuation that makes it appropriate to an open-ended fund and it is the redemption policies that can be invoked in times of extreme liquidity stress that determine whether the redemption frequency is appropriate.

### **Issue 10 – Article 20 Delegation of AIFM functions**

Measures in this area should be sensitive to the considerable variety of AIFM that will fall within the scope of the Directive, both in terms of their size and the types and structures of AIF that they manage.

## **Part III: Transparency Requirements and Leverage**

### **Issue 19 - Article 4 Definition of leverage**

It is essential that leverage achieved through secured long term borrowing is distinguished from leverage embedded in derivative positions because the two forms of leverage have different risk profiles. The calculations need to reflect the different forms that leverage can take.

### **Issue 20 - Article 22 Annual report**

The contents of the annual report should make a clear distinction between the financial statements and other content. The content and format of the financial statements are a matter for the accounting standards applicable in the AIF's home Member State. The Commission should restrict its rule making to the other content of the annual report.

Accounting standards generally allow flexibility in the presentation and content of the primary statements such that they can be tailored to suit the operation of the entity in question. The Commission's guidance should not override this approach in respect of the financial statements.

### **Issue 21 - Article 23 Disclosure to investors**

The Commission appears to be seeking advice regarding the frequency of disclosure in respect of article 23(4) although there are no implementing powers in this respect.

The information required by article 23(4) and (5) should be disclosed only in the annual report unless it amounts to such a fundamental change to investors' rights or expectations that their prior approval of the change should be sought.

International accounting standard IFRS 7 requires extensive narrative and numerical disclosures about an entity's risk profile and the management of those risks.

#### **Issue 22 - Article 24 Reporting obligations to competent authorities**

As discussed under issue 19, it is essential that leverage achieved through long term borrowing is distinguished from leverage embedded in derivative positions.

#### **Issue 23 - Article 25 Use of information by competent authorities, supervisory cooperation and limits to leverage**

As discussed under issue 19, it is essential that leverage achieved through long term borrowing is distinguished from leverage embedded in derivative positions. It is common for real estate funds to finance their investment activities using a combination of debt, in the form of long term borrowing from banks, and equity, in the form of shares or units issued to investors. The real estate assets will be used to provide security for the loans. This use of leverage does not contribute to the build-up of systemic risk in the financial system or the risk of disorderly markets.

Imposing limits on the level of leverage on secured borrowers such as real estate funds creates a risk of a loss of investor protection. When real estate values fall the level of leverage rises and imposing leverage limits on borrowers in such circumstances would force them to sell real estate assets at the most disadvantageous point in the economic cycle. This would be contrary to investors' best interests.

### **Part IV: Supervision**

#### **Issue 24 - Cooperation arrangements between European competent authorities and the authorities of third countries**

##### **Issue 24a - Cooperation arrangements without a third country passport**

These arrangements relate to the national placement regimes that will be phased out following the introduction of the passport for third countries. As such they amount to transitional arrangements and should reflect as far as possible existing bilateral arrangements between individual Member States and third countries.

##### **Issue 24b - Cooperation arrangements with a third country passport**

Third country AIFM will not be able to apply for authorisation for a further two years after the final transposition date so the question of cooperation arrangements in relation to the third country passport should be considered at a later date.

#### **Issue 26: Authorisation of non-EU AIFM**

Third country AIFM will not be able to apply for authorisation for a further two years after the final transposition date so the question of determining the Member State of reference should be considered at a later date.