NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

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Re: Directive on Alternative Investment Fund Managers
Interinstitutional File: 2009/0064(COD

Gentlemen:

The National Association of Real Estate Investment Trusts® (NAREIT) is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

NAREIT recently became aware of the above-referenced proposed Directive and how it could be applied to U.S. listed REITs and other publicly traded

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companies that sell their securities to EU investors. We find its potential impact on listed U.S. REITs startling, surprising and significantly at odds with the perspective, practice and policy on REITs in the U.S. We urge the European Commission not to apply the Directive to U.S. REITs for a simple reason: REITs have been recognized by the market, governmental regulators and ratings agencies to be operating businesses rather than passive funds, and therefore it would be inappropriate to treat listed U.S. REITs as investment funds under the Directive.

Background

Evolution of REITs Recognized by the Internal Revenue Service

The United States Congress created a tax election for REITs in 1960 to allow investors large and small to invest in large-scale commercial real estate projects such as apartment communities, office buildings, shopping malls, industrial warehouses and lodging and health care facilities and receive the benefits of professional management. Under the U.S. REIT regime (mirrored today by more than 30 countries, including the leading economies of the European Union), investors purchase stock of a REIT and elect its board of directors the same as any other business.

A U.S. REIT has always been regulated the same as any other corporation doing business in the United States, *e.g.*, it must follow the same rules of the Securities & Exchange Commission as does Google or General Electric. The major differences with other U.S. corporations are that the REIT tax rules require companies electing to operate under those rules to focus on the commercial real estate business and to distribute at least 90% of their taxable income each year as dividends to their shareholders. In exchange for meeting those requirements, a REIT deducts from its taxable income all dividends it distributes to its shareholders.

The original REIT structure, as enacted in 1960, was a passive investment vehicle, and the Internal Revenue Service (IRS) recognized it as such. In Revenue Ruling 73-236[1], the IRS considered whether a REIT's rental activities could satisfy the standard required for a tax-free "spin-off," *i.e.*, that both the distributing and distributed corporation engage in an "active trade or business," which is a much higher standard for an operating business compared to the traditional "trade or business" standard. The IRS concluded that the REIT could not meet the active trade or business standard because, under the tax rules at that time, a REIT could not directly perform substantial management and operational activities.

In 1986, the U.S. Congress changed the REIT tax rules significantly by allowing REIT employees to perform all customary services for their tenants. This legislative modification laid the groundwork for the "modern REIT era," which blossomed in the early 1990s with the successful initial public stock offerings of previously private real estate operators. The new REITs used the cash raised from the sale of common stock to pay down their debt that could not be refinanced as a result of the savings and loan crisis and to acquire new properties and real estate businesses. The market allocated capital to this new wave of REITs because the managers had proven track records of sophisticated management, operational skills, development

[1] 1973-1 C.B. 183.

capabilities and leasing experience with commercial real estate. As summarized by a leading investment banking firm:

> [T]he original REIT structure created in the 1960s was a passive investment vehicle; it prohibited the operation and management of properties by the REIT itself. Over the years, however, legislative and tax code changes have enabled REITs to become actively managed, fully integrated operating companies…. When REITs were passive investment vehicles, all that mattered was asset performance. Now that REITs are bona fide operating companies, management has the power to improve or, conversely, weaken that operating performance, as well as that of the overall enterprise. Good management aims to produce significant and efficient returns for the REIT's portfolio, and guides the REIT through difficult markets.[2]

In 2001, the IRS recognized the fundamental change in REITs that Congress made in 1986 by modifying its 1973 advice to conclude that a REIT may indeed engage in an active trade or business under the strict spin-off standard because it "is permitted to perform activities that can constitute active and substantial management and operational functions with respect to rental activity that produces income qualifying as rents from real property."[3] In other words, the IRS now recognizes that a REIT is an operating business rather than a passive manager akin to an investment fund.

Institutional Investor Perspective

The IRS is far from alone in acknowledging the operating nature of listed U.S. REITs. Standard & Poor's (S&P) operates a series of world-class indexes (*e.g.*, the S&P 500) that are used as benchmarks for trillions of Euros worth of investment. Before 2001, S&P excluded REITs from its indexes because it had believed that REITs continued to be passive investment vehicles.

On October 3, 2001, S&P announced that, after a thorough review, it had decided to include REITs in all of its broad equity indexes. According to the S&P press release, the decision showed that Standard & Poor's "believes that REITs have become operating companies subject to the same economic and financial factors as other publicly traded U.S. companies listed on major American stock exchanges." Currently, 14 REITs are included the S&P 500, 25 are included in the S&P 400 and 27 are included in the S&P 600.

Government Classification

For many years, the United States government used the Standard Industrial Classification (SIC) system as the standard used by Federal statistical agencies in classifying business establishments for the purpose of collecting, analyzing, and publishing statistical data related to the U.S. business economy. In 1997, the United States, Canada and Mexico adopted the North American

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[2] *REITs 101: An Introduction*, Barclays Capital Equity Research (April 7, 2010).
[3] Rev. Rul. 2001-29, 2001-26 I.R.B. 1348.

Industry Classification System (NAICS) to replace the SIC system and to apply it to all of North America. The process to adopt NAICS started in the late 1980s before the "modern REIT era."

As originally adopted in 1997, NAICS classified all REITs in the category of "Funds, Trusts and Other Financial Vehicles" along with mutual funds and other passive investments. In 2006, all three North American governments changed NAICS to move "equity REITs" (REITs that focus on operating rental real estate) from the financial vehicle sector to the "Lessors of Real Estate" sector, where the SIC system and NAICS had traditionally classified active real estate operators.[4] This change was another official recognition of the evolution of REITs following the 1986 tax legislation from passive investment entities to fully-integrated operating companies.

Directive Should Not Apply to Listed U.S. REITs

Section 1(a)(i) of article 3 of the Directive defines an alternative investment fund as "any collective undertaking including investment compartments thereof which raises 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." In its broadest sense, this definition could apply to any company that raises funds from investors to invest in businesses, and the fifth Recital indicates that an AIF can be either open ended or closed-ended, listed or non-listed and internally or externally managed. However, Recital 5(b) provides that the Directive shall not apply to:

> holding companies insofar as they are parent undertakings of a group, within the meaning of Article 2 (12) of the Directive 2002/87/EC of the European Parliament and of the Council, and the main purpose of the group is to carry a business strategy by producing and selling goods and/or providing services, except for collective investment services, to the customers of the group as evidenced, for instance, by the description of the main activities of the group in their instruments of incorporation, the group annual report or the relatively low importance of non-current investments on the consolidated group balance sheet.

Similarly, Recital 5 of the European Parliament's draft excludes "an undertaking which principally acts as a holding entity for a group of subsidiary undertakings and which owns strategic stakes in undertakings with a view to long-term holding rather than for the purpose of generating returns through divestment within a defined time-frame." Simply put, NAREIT believes that listed U.S. REITs squarely fall within this exception, and requests that the final Directive specify this exception.

A listed U.S. REIT is typically a holding company that has dozens if not hundreds of either partnership or corporate subsidiaries that provide a range of services to third parties in connection with renting space such as maintaining common areas, marketing the buildings, heating and air conditioning, telephone and internet services, providing security, repairing all common areas and redeveloping assets, all of which are described in the multiple filings required by the Securities and Exchange Commission. Over the years, the Internal Revenue Service has greatly expanded the type of services a REIT can provide its tenants. Additionally, since 2001 a

[4] 71 Fed. Reg. 28533 (March 16, 2006). These changes became effective in 2007.

REIT can have up to 25% of its assets in one or more taxable corporations that can provide virtually all services to both tenants and non-tenants.

Further, the tax rules require that REITs be long-term investors in real estate rather than a short-term “dealer.” If a REIT acts as a dealer, it must pay 100% of its profits in the form of an excise tax to the Internal Revenue Service. In addition, by virtue of being listed, U.S. REITs are infinite life companies that need not divest “within a defined time-frame.” Accordingly, listed U.S. REITs satisfy all the requirements for being exempted under the fifth Recital of the Directive.

We note that listed U.S. REITs are overwhelmingly internally managed by a large number of full-time executives with a diverse range of skill sets, *e.g.*, capital markets, finance, investor relations, leasing, risk management, development, redevelopment, information technology, marketing, legal, purchasing and selling assets and actually operating their properties.[5] Each REIT develops long-term business plans and is judged by the marketplace by how well they execute those plans and operate their businesses. Unlike investments funds, listed U.S REITs generally trade at either premiums or discounts to their net asset values because the market values each company’s ability to generate earnings growth as opposed to the static value of the company’s existing assets. *See* Attachment A for a leading analytic company’s estimate of the aggregate premiums and discounts to net asset values from 1990 to this year.

We thank you for the opportunity to present the reasons why NAREIT believes that the Directive should not apply to listed U.S. REITs. We would be pleased to meet with you to discuss our perspective in greater detail.

Respectfully submitted,

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Executive Vice President & General Counsel

cc: Sharon Bowles
Pascal Canfin
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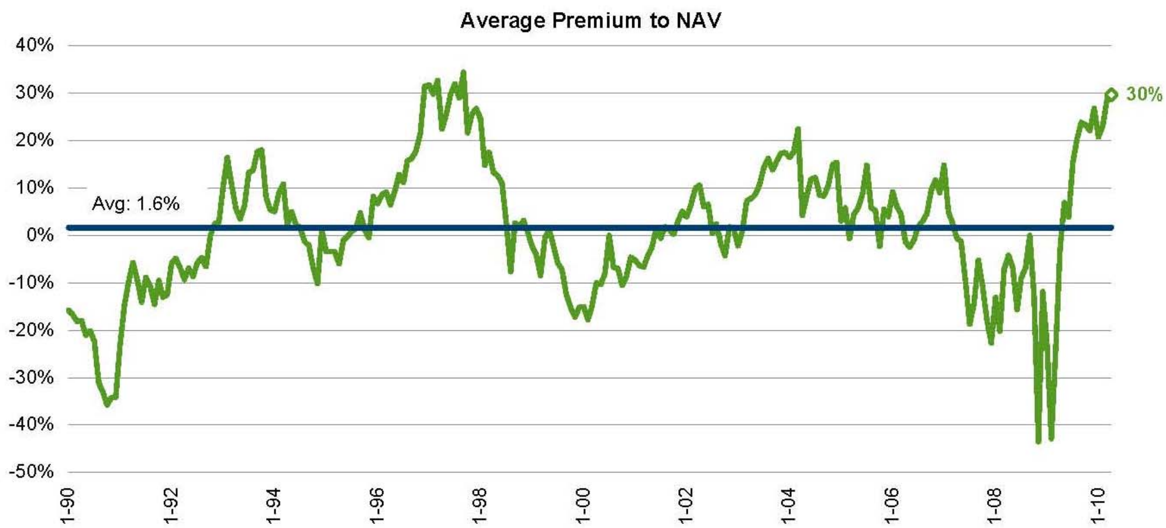
[5] NAREIT’s annual *Compensation Survey* aggregates data on around 100 positions commonly found in its member companies.

Attachment A

REIT Valuation - A Macro View
Public Market Real Estate vs. Fixed Income

NAV Premiums: Observed NAV premiums/discounts in the public market have historically been reliable predictors of future changes in private-market prices*. While false signals can occur, large premiums usually precede rising property values, and vice versa.



Weighted average (weighted by NAV*shares outstanding) of all US-listed companies in Green Street's coverage universe, excluding Hotels and those without a published opinion. Equally-weighted average prior to Jan '93.

*This predictive power can be viewed here: www.greenstreetadvisors.com/research/view/RMZforecastbacktest.pdf.

Warranted Adjustment in Public Market Real Estate Prices:

Observed Premium to Unleveraged Asset Value (major property sectors)**	12%
Combining the change in unleveraged private-market values that *should* occur (prior page) with the change that is "baked into" public-market values, the change to implied de-levered public-market values that should occur is...	-3%
Considering that the average ratio of equity market-cap to asset value is...	55%
The expected change in REIT share prices is...	-5%
Based on pricing benchmarks from the fixed-income market, the fair value for the RMZ is...	**707**

**The premium to NAV shown in the top graph is for all REITs; the premium to unleveraged asset value (and all other aspects of this analysis) pertains solely to the five major property sectors. Premiums to asset value are absent the distortive effect of leverage.

