

REIT ALERT

November 19, 2014

REITs and the Alternative Investment Fund Managers Directive

SPEED READ

The implementation of the Alternative Investment Fund Managers Directive throughout the European Union may have implications for REITs in the United States if they are determined to be alternative investment funds or "AIFs". While the AIFMD rules are evolving, U.S. REITs should be prepared to differentiate themselves from AIFs. This alert examines some areas that should be explored when preparing to make such a distinction.

Introduction

The Alternative Investment Fund Managers Directive, or AIFMD, has now been implemented throughout the European Union. These rules generally impose various registration and reporting requirements on the managers of "alternative investment funds," or AIFs. These requirements apply even to non-EU managers of non-EU AIFs if the AIF is raising equity capital in the EU.

In our October 29, 2014 Client Alert, "The Alternative Investment Fund Managers Directive One Year On—A Guide for Non-EU Managers", we discuss the current state of the AIFMD, its requirements and staged implementation across the EU. In this REIT Alert, we focus on how the AIFMD might impact REITs in the United States and examine the status of REITs as possible AIFs under the new rules.

Capital raising is increasingly global. Even for strictly U.S. domestic REITs, underwriters and placement agents routinely seek to add a European tranche to U.S. offerings. This is true whether the transaction is an underwritten public offering, bought deal and/or private placement. Moreover, for REITs that have acquired, or are considering acquiring, assets in Europe, access to the European real estate investor base may be a key strategic goal or advantage.

The ability to raise equity capital in Europe on an equal footing with all other U.S. public companies is becoming increasingly important to U.S. REITs, of whatever variety or sector. As such, determining whether and how the AIFMD may affect capital raising activities by U.S. REITs in Europe is becoming a gating question when considering capital raising strategies.

As discussed below, the EU rules defining an AIF are broadly written and may implicate business entities and enterprises that would not otherwise have considered themselves "alternative investment funds". Many U.S. REITs whose equity securities are listed for trading on major exchanges would have no reason to consider themselves AIFs any more than operating companies in any industry other than real estate. Unfortunately, the AIFMD provides no blanket exemption for REITs and, to date, among REITs formed in EU jurisdictions, some have concluded that they are AIFs and their managers have registered under the AIFMD. As more fully addressed below, we believe that the structure and operations most publicly-traded U.S. equity REITs will enable them to sufficiently differentiate themselves from the type of investment entity intended to be covered by the AIFMD to conclude that they are not AIFs.

AIFs Under the AIFMD

The primary targets of the directive are unregulated alternative investment funds and their managers. "Alternative investment funds" are defined in the directive as:

"... collective investment undertakings, including investment compartments thereof, which:

(i) raise 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; and

(ii) [are not EU regulated retail UCITS schemes];^[1]

The European Securities and Markets Authority ("ESMA" – the college of EU regulators whose task it is to create unity of interpretation throughout the EU) has given guidance on the term "collective investment undertaking". It believes that an AIF does not include a vehicle that has a general commercial or industrial purpose, meaning:

"the purpose of pursuing a business strategy which includes characteristics such as running predominantly:

(i) a commercial activity, involving the purchase, sale, and/or exchange of goods or commodities and/or the supply of non-financial services, or

(ii) an industrial activity, involving the production of goods or construction of properties, or

(iii) a combination thereof.^[2]

How to distinguish between an investment undertaking and a commercial entity is often not easy. In a series of submissions to EU regulators during the course of the AIFMD drafting and implementation process, the National Association of Real Estate Investment Trusts urged regulators and other participants in the process to clarify generally the scope of the AIFMD and particularly with respect to its application to REITs.^[3] In addition, the nature of the AIFMD as an EU directive, rather than an EU regulation, means that it needs to be transposed into law on a country-by-country basis. This has resulted in some differing national interpretations on, among other things, the precise characterization of an AIF.

Is a REIT an AIF?

To decide whether any particular REIT is an AIF, all relevant operational facts and circumstances must be considered. Note that, while counter-intuitive, none of the following non-operational factors is really relevant in making this assessment:

- an entity is a public REIT traded on a national securities exchange;
- REITs are treated as commercial enterprises in the United States and included as such in major equity indices such as the S&P 500; or
- a REIT's income may be treated as operating income rather than investment income for tax purposes.

These may be all true but do not, in and of themselves, automatically mean that a REIT is not an AIF for purposes of the AIFMD. Instead, the focus must be on the operational and commercial characteristics of the company. In the table below, we have summarized general operational and commercial characteristics of typical U.S. publicly traded equity REITs versus those of an AIF. The two criteria we believe to be most significant to the analysis are highlighted in italics, but no single criterion on its own is determinative.

<u>TYPICAL U.S. REIT</u>	<u>AIF</u>
<i>A business which acquires, constructs, refurbishes, develops and provides services related to land and buildings</i>	<i>An entity that merely holds property to take advantage of changing market prices or (rental) income streams</i>
Corporation having perpetual existence and one or more classes of permanent equity capital	Fund with a pre-defined finite life, often contingent on the investment goals or status of individual investors
<i>Substantial number of employees from junior personnel to executive board directors to operate the business. Executive directors are paid at the level of executive directors generally</i>	<i>A largely skeleton staff or no staff at all, with mainly non-executive directors</i>
Frequent board meetings at which major business is decided	Infrequent board meetings
Little outsourcing of major functions, with appropriate personnel in house to supervise any outsourced activities	Activities frequently outsourced to third parties, including third-party managers and with little ability to supervise outsourced activities
Investment policies that may be changed at the board's discretion	Changes to investment policies normally require some form of investor consent
Typically raises capital for itself by itself to fund its development activities, commercial business strategy and commitments	Typically raises capital through a "sponsor" that plans (itself or through a group member) to make a profit out of the management of the capital raised from third party/external sources
Issues debt in the public and private markets that is subject to ratings agencies review	Typically does not widely issue debt securities to the market and does not have rated debt securities

Whether or not an issuer is an AIF is up to each individual issuer to determine in consultation with its advisors. The criteria listed above are not exhaustive; in any given circumstance there are likely to be additional factors unique to the specific company that may have the effect of making it more or less like an AIF.^[4]

European REITs

In this regard, it may be helpful for U.S. REITs to note the views taken by their EU counterparts to date. Property vehicles in the EU generally fall into three distinct categories (although working out which category is relevant for a particular REIT is not necessarily so easy):

- **True-Commercial Property Vehicles.** Companies that undertake property construction or development-for-sale businesses are clearly not AIFs. Given the relevant tax rules, though, they are also not likely to be REITs either. Examples in the EU include Persimmon plc and Quintain Estates and Development plc, or Barratt Homes, the house builder.
- **Property Investment Vehicles.** Various EU REITs have classified themselves as AIFs under the AIFMD, including, for example, *Standard Life Investments Property Income Trust Limited*, *Picton Property Income Limited*, *Tritax Big Box REIT plc* and *Green REIT plc*. In very general terms, the purpose of all four vehicles is to produce income and capital growth by investing in a portfolio of commercial properties; day-to-day activities are often outsourced to an investment manager and administrator (although Green REIT plc is self-managed) and changes to the investment policy may be made only with shareholder approval. Importantly, none of these entities has other than a token number of employees.
- **"Mixed activity" REITs.** The classification of these vehicles is more difficult since they undertake a mixture of development and investment activities. Two UK entities are helpful examples, *British Land plc* and *Great Portland Estates plc* — neither has classified itself as an AIF. In both cases, they have a significant number of employees (more than one hundred in each case), with a board of directors that meets frequently to take business decisions. Directors are paid as fully active executives.

Conclusion: Next Steps for U.S. REITs

As noted above, whether or not a U.S. REIT is an AIF is up to the individual company to determine in consultation with its advisors. While the notion of a REIT as a commercial operating company is uniformly accepted in the United States, U.S. REITs will need to affirmatively

determine their status under the AIFMD in advance of any equity capital raising activities in the EU.

To be sure, the AIFMD rules are new and regulatory practice is still evolving. Moreover, as noted above, not all EU jurisdictions are necessarily taking exactly the same approach to interpretation or enforcement. Nevertheless, at this point U.S. REITs should at least have a plan. We believe that based on the factors discussed above and in consultation with appropriate advisors, many U.S. equity REITs will be able to sufficiently differentiate themselves from AIFs, taking into account both the general and unique operational characteristics of each individual company.

* * * * *

Please contact any of the attorneys below if you have questions about the issues raised in this REIT Alert.

[1] Article 4(1)(a).

[2] See page 29 of the Final Report here.

[3] See the documents available at <http://www.reit.com/nareit/policy-issues/cross-border-issues/eus-alternative-investment-fund-managers-directive-0>.

[4] See, e.g., letter dated January 31, 2013 from the National Association of Real Estate Investment Trusts to ESMA, highlighting other possible differentiating factors between operating businesses and funds, including applicable regulatory regime and valuation metrics.

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