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Marketing U.S. REITs to European Investors: Are you subject to the Alternative Investment Fund Managers Directive?

Introduction

This guide is aimed at U.S.-domiciled real estate investment trusts (REITs) and their advisers who wish to market in the EU¹ following the implementation of the Alternative Investment Fund Managers Directive (the Directive).

For clarity, this guide focuses on the position under the current law and guidance in the United Kingdom, which may differ from that in other EU member states. REITs should note that it is critical to confer with local counsel in each EU member state before marketing in that EU member state.

This note is written as a general introductory guide only. It should not be relied upon as a substitute for specific legal advice.

Overview

The Directive is part of a suite of complex rules that has a material impact on all funds (wherever domiciled) managed in the EU or marketed in the EU or to any person domiciled or with a registered office in the EU (EU investors).²

The Directive applies to "alternative investment funds" (AIFs). This is a broad concept that captures private equity, venture capital, real estate, hedge and infrastructure funds and investment companies. It also captures many investment entities that do not traditionally regard themselves as funds. A REIT that is an AIF must comply with onerous additional obligations in order to market to EU investors.

Despite extensive industry lobbying, there is no "safe harbor" for REITs, some of which may be AIFs. Each REIT will need to carefully consider whether it is an AIF prior to conducting any fundraising³ activities with EU investors.⁴

This guide provides an overview of the elements of the definition of an AIF that REITs will need to consider in determining whether the Directive applies to them.

Penalties for failure to comply can be severe but vary from EU member state to EU member state – for example, in the United Kingdom "unlawful marketing" may amount to a criminal offense and investors may



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reclaim their invested money as well as compensation for any losses sustained - so it is critical that REITs understand and adhere to these new rules if they apply.

In the United Kingdom, penalties for "unlawful marketing" apply to the REIT (or any external manager) as well as any underwriter marketing on behalf of the REIT (or any external manager).

What is an AIF?

An AIF is defined as:

- a collective investment undertaking
- that raises capital from a number of investors
- with a view to investing that capital in accordance with a defined investment policy for the benefit of those investors.⁵

There are only a very limited number of exemptions, meaning that a wide range of vehicles could be caught by this definition, including certain REITs. The lack of exemptions in the legislation is deliberate.

That being said, the Directive focuses on investment undertakings, and "ordinary companies"⁶ are expressly outside its scope. A typical equity REIT may be able to contend that it is not within the Directive's scope on this basis. However, in order to do so, it will be necessary to carry out an analysis of a particular REIT's characteristics in light of the regulatory guidance available on this issue.

Given its relevance to equity REITs, the remainder of this guide focuses solely on this "ordinary company" issue. If a REIT is an "ordinary company," it will not be considered an AIF; however, if a REIT is not an "ordinary company" or the analysis is not conclusive, then it may be an AIF, and further analysis will be necessary to reach a conclusion.

"Ordinary Companies": A UK perspective

The guidance issued by United Kingdom's Financial Conduct Authority (the FCA), one of the more "business-friendly" of the EU regulators, discusses the concept of an "ordinary company" in detail. It sets out a number of factors that are indicative (but not conclusive) of a business either being an "ordinary company" or an AIF.⁷

Although this guide does not propose to set out these factors in full, and any analysis should consider all applicable facts and circumstances, we believe that when the following factors are present in an equity REIT, this strongly supports the conclusion that the REIT is an "ordinary company" and not an AIF:

- The REIT, like most equity REITs, does not simply hold real estate to take account of changing market prices or income streams, but carries out commercial activities, such as the development or redevelopment of properties.
- The REIT is an operating business with a substantial number of employees over and above the number necessary to simply ensure that investment values of properties are maintained, including employees performing commercial activities such as on-site property management activities and development and redevelopment activities.
- The REIT does not outsource its core operations.
- The REIT's board includes executive officers with executive compensation packages, and the REIT's board or its committees meet more frequently than just quarterly.
- The REIT does not have a defined mechanism for the return of capital to investors, such as a targeted liquidation date.
- The REIT is not marketed as an investment fund.

What do REITs need to do?

Prior to undertaking any fundraising in the EU or with EU investors, it is essential for REITs and their advisers to identify whether the REIT in question is an AIF or not. **We recommend that REITs, with the assistance of their advisers, perform this analysis now rather than at the time of an actual securities offering, when there may be significant time constraints.**

If it is an AIF, the REIT will need to comply with certain parts of the Directive as well as the national private placement regimes of each EU member state in which they wish to market, some of which impose onerous and time-consuming requirements. For example, a REIT that is an AIF wishing to market to German investors will need to, among other things, appoint a depositary to provide certain custody and oversight services and seek

approval from the German regulator, a process that can take several months, in each case prior to any marketing.

If the REIT is not an AIF, any promotional activities will need to be carried out in compliance with local securities laws, but the additional burden of the Directive will not apply.

How can Hogan Lovells help?

Hogan Lovells, with its market-leading REIT practice and highly-regarded global investment funds practice with practitioners throughout the EU and the U.S., is uniquely qualified to assist REITs with this analysis.

- Our transactional lawyers, in collaboration with our regulatory practitioners, have already advised many REITs, real estate managers, and real estate trade bodies on their position under the Directive. We have a practical understanding of the regulation and the regulatory environment and extensive experience in the industry.
- We have also advised numerous AIFs and their managers on the impact of the Directive on the operation, management, and marketing of such AIFs. This enhanced insight into the Directive allows us to provide clear guidance about what U.S. REITs need to do to be compliant.

Further information

If you would like further information on the subject matter discussed in this note, please contact your relationship partner at Hogan Lovells or any of the lawyers listed on the right hand side of this alert.

1. For ease of reference, the term "EU" as used in this memorandum includes Norway, Iceland, and Liechtenstein, which together with the 28 member states of the European Union form the European Economic Area.
2. EU Directives do not apply directly across the EU, rather they have to be implemented into the national law of each EU member state, and it is the national law that has effect. Although the legislative intention is that the Directive apply harmoniously across the EU, the national level implementation has resulted in the law being applied inconsistently across the EU. REITs and their advisers therefore cannot rely on the interpretation in one EU member state as applying in another. To minimize this, the European Securities and Markets Authority (ESMA) has published guidelines to aid EU member states in their interpretation and implementation of the Directive, which it can update from time to time.
3. Fundraising by way of an issue of conventional debt securities should not be restricted by the Directive, whether a REIT is an AIF or not.
4. "Marketing" under the Directive has been interpreted in different ways. Certain EU member states require formal registration under the Directive prior to any contact being made with prospective investors; others permit test marketing without compliance, only requiring notification and compliance prior to shares being made available to acquire.
5. We understand that some equity REITs have focused their analyses on the need for a defined investment policy, arguing that a broad investment policy that can be changed without investor approval does not qualify as being "defined". While this argument is persuasive, particularly when compared to a typical real estate fund where a detailed, enforceable, and fixed investment policy is a key component, because the Directive was clearly intended to cover certain hedge funds with similarly broad policies that can be changed without reference to the investors, and because certain regulators have determined these policies to be sufficiently "defined," the position is not certain, and equity REITs should not rely solely on this argument.
6. The term "ordinary company" was replaced in later guidance issued by ESMA by the concept of an undertaking having "a general commercial or industrial purpose". Ordinary company is used in this note for simplicity.
7. The FCA guidance only applies in the United Kingdom. Although the intention is that the Directive is applied in a consistent manner across the EU, it is very possible that some other EU member states will interpret the provisions differently. A REIT proposing to raise funds on a pan-European basis should therefore consider whether to seek advice in respect of each EU member state in which it intends to market.

About Hogan Lovells

Hogan Lovells is an international legal practice that includes Hogan Lovells US LLP and Hogan Lovells International LLP. For more information, see <http://www.hoganlovells.com>

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