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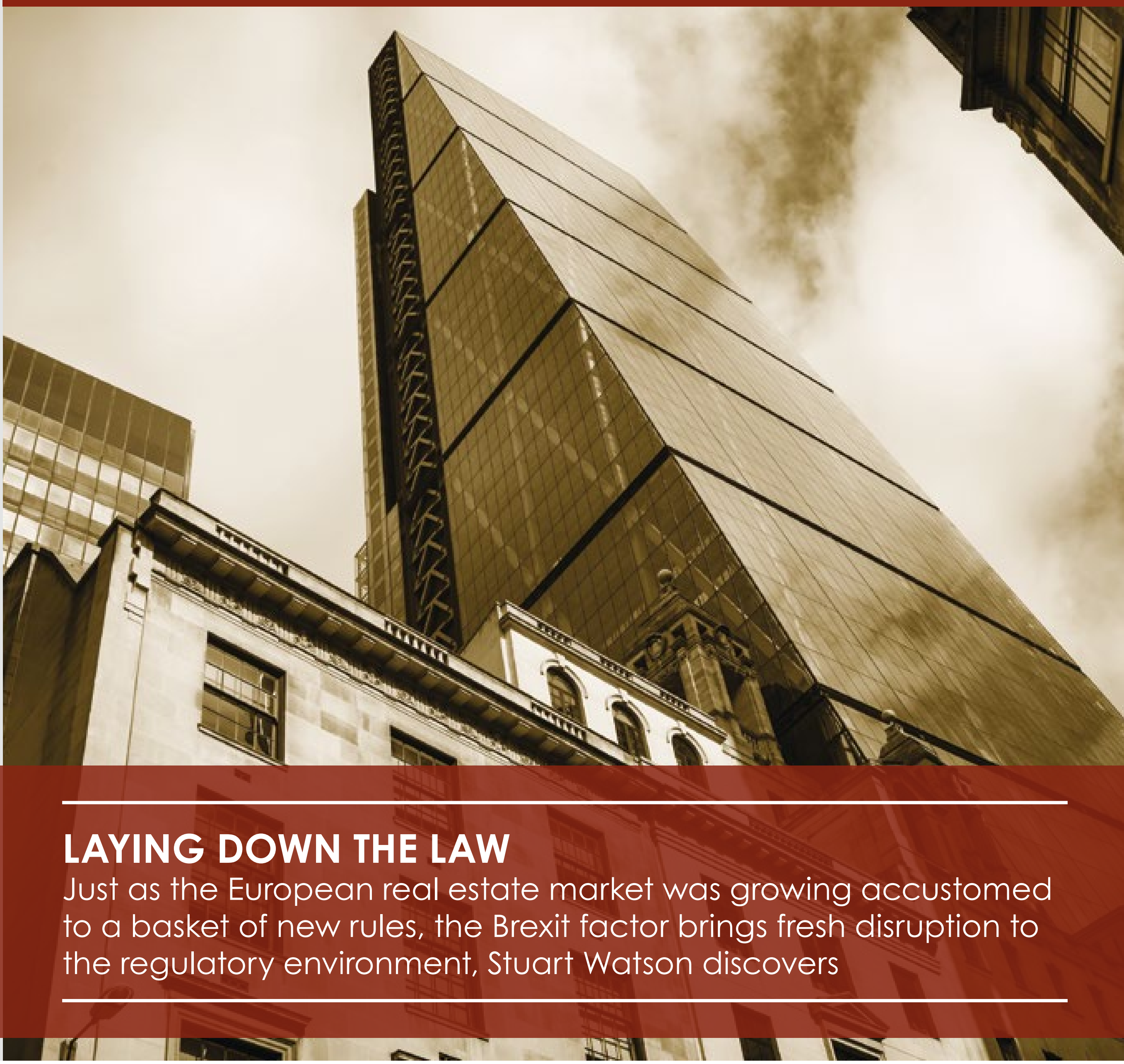

LAYING DOWN THE LAW

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From left: Ian Laming, Ian Baker, Simon Burgess and Anita Lyse

Laying down the law

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Photography by James Clarke

Since the global financial crisis, a spate of regulation, much of it aimed at protecting investors, has transformed the European real estate investment market. Whether that regulation has been desirable or effective, investment managers have gritted their teeth and worked their way through the ensuing stacks of paperwork.

But just when the real estate industry thought the machine was running smoothly again, the UK's referendum on EU membership has thrown a Brexit-shaped spanner into the works. How will Britain leaving the EU affect the regulations now in place? Will the UK be able to retain its pre-eminent position within the European property market without being part of EU structures, or will it be eclipsed by other jurisdictions?

Meanwhile, the Alternative Investment Fund Managers Directive is up for review and the effects of the Solvency II directive regulating European insurers and OECD/G20 measures to reduce tax evasion and profit shifting are being felt.

PERE brought together four experts in real estate investment regulation for a roundtable discussion at the offices of investment manager Tristan Capital Partners in London to mull over these and other European regulatory issues.

Present were two representatives of the fund management industry, Tristan's chief operating officer Ian Laming and Rockspring Property Investment Managers' partner in charge of finance and compliance, Ian Baker. They were joined by senior professionals from two fund administration service providers, Anita Lyse, head of real estate at Alter Domus, and Simon Burgess, a chartered surveyor and managing director of Ocorian.

At the top of the agenda is Brexit. For the two London-based fund managers it may soon have a direct impact on the activities their businesses can carry out in the UK. For Lyse and Burgess, whose businesses have offices in both Luxembourg and Jersey, it could mean investors increasingly favor those territories.

When the UK leaves the EU it could become a 'third country' outside the passporting arrangements that allow EU managers complying with the AIFMD directive to market their products across the region. Currently, non-EU managers must comply with each EU member's national regime when they market funds in that country through the 'private placement' process.

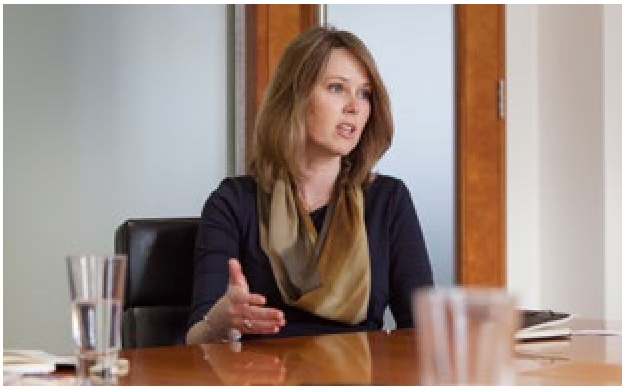
After Brexit, the UK parliament may hope that by keeping legislation unchanged it will be granted equivalence to EU law, so that passporting arrangements will remain as they are. Alternatively, the EU is considering the extension of the AIFMD passport to a number of non-EU third countries, including Guernsey, Jersey, Hong Kong, Singapore, Switzerland and the US, and post-Brexit Britain could be added to the list. Much will depend on whether the UK is also accepted as an AIFMD-passported, non-EU country, suggests Burgess: "With the UK being such a significant player in the EU today, part of Brexit negotiations has to be the development of the UK as the first 'third country' into Europe. The most important thing here is for Britain to negotiate terms very carefully so that it is accepted through the AIFMD passporting arrangements. That said, for a lot of my clients the private placement regime is of key importance and Britain has the ability to play in that market as well."

"Many fund managers are already beefing up their Luxembourg operations. It is the top of the list of alternative EU locations"
Anita Lyse

Lyse doubts that a UK outside the EU will be granted an immediate passport, however. "There have been no signals in the market that Britain will be able to skip the queue to get equivalence before any of the other countries. Britain will at some point no longer be part of the EU and it will likely have to join the same queue as all the other third-party countries," she says.

Because of the uncertainties of the political process that will lead to Brexit, Tristan's Laming says managers have no option but to plan for a "cascading series of scenarios," with alternative business plans based not only on Britain being granted a passport or the EU accepting the equivalence of UK law, but also provisions for a manager to relocate some parts of its regulated activities to an EU country if the UK ends up outside the existing arrangements.

Baker thinks there is still some time available for managers to watch events unfold and figure out the best approach. "If Article 50 is triggered at the end of March, we probably have 12 months, which is a pretty good lead in time to make a decision. Hopefully we will get some kind of access or there will be equivalence. Perhaps there will be interim arrangements. If we are told in January 2019 that there will be no passporting



Lyse: fund managers are already beefing up their Luxembourg operations

Ian Baker

Partner – finance ; Rockspring Property Investment Managers

Baker is one of the founder shareholders of Rockspring, and has been with the firm for 30 years. He is responsible for the European property investment fund manager's strategic financial planning, including the implementation of the corporate, financial, tax and debt structures for all client funds, asset acquisitions and disposals. He is also the company's compliance officer.

Simon Burgess

Managing director; Ocorian

Burgess leads the funds service line at Ocorian, an international financial services business providing outsourced administration, fiduciary and accounting services. Based in Jersey, he specializes in the establishment of multiple-jurisdictional investment platforms with an emphasis on real estate, infrastructure, debt and private equity fund assets. Burgess has more than 30 years' experience in the funds and property investment industry.

Ian Laming

Chief operating officer; Tristan Capital Partners

Laming is COO, senior partner and member of the investment committee at London-based real estate investment manager Tristan Capital Partners. He has more than 20 years' experience in global securities investment management, investment banking and investment research. Prior to Tristan, Laming was co-head of Morgan Stanley's European equity and fixed income research division and an investment manager at investment partnership Baillie Gifford.

Anita Lyse

Head of real estate; Alter Domus

Lyse is head of real estate at the global fund and corporate services provider Alter Domus and responsible for the development of the firm's business, service offering and product suite within the real estate segment. She joined in 2001 and has worked with some of the world's largest private equity and real estate funds, developing expertise in the management and administration of the funds and special purpose vehicles set up by such investors.

or equivalence and everybody then submits their applications for getting an authorized vehicle set up in Luxembourg, the regulator won't be able to deal with that number of applications at once, so we all need to think ahead and have our plans in place," he says.

The dynamics of supply and demand will force politicians to come up with a workable solution, predicts Laming. "I believe that pragmatic politics will prevail because there is a large base of European insurance and pension fund managers that need access to managers in London. If that access is threatened, the biggest and most vocal proponents of keeping UK managers in the fold in the coming months and years will be the investors themselves," he argues.

Nexus of activity

Some managers with UK offices are already considering setting up additional operations in the EU to protect their rights to an AIFMD passport. It was reported in January that US private equity firms Blackstone and Carlyle are applying to set up operations in Luxembourg, although neither company has publicly confirmed their intentions.

Baker says: "Luxembourg is the obvious alternative center to be regulated in within the EU because there is a precedent of allowing regulated entities to operate with a minimal residence while outsourcing a lot of their fund management activities back to the UK. Countries like France would insist that you move lock, stock and barrel and set up residence there."

Luxembourg has benefited from the Brexit effect, claims Lyse: "Many fund managers are already beefing up their Luxembourg operations with an AIFM in Luxembourg and a Luxembourg-domiciled, regulated or unregulated fund. It is the top of the list of alternative EU locations, although Ireland is also an option for some because it has the Anglo-Saxon link, which could be important for some UK managers."

Lyse argues that Luxembourg was already an attractive

Baker: 'Luxembourg is the obvious alternative center to be regulated in within the EU'

Burgess: 'A lot of my clients and their investors say AIFMD doesn't serve any beneficial purpose for them'

destination for managers even before the prospect of Brexit. She credits the stability of its regulatory framework, supported by national legislators and authorities keen to attract fund management business. The creation of innovative new fund structures, including the Reserved Alternative Investment Fund, which can be launched much more quickly and easily than a standard regulated AIF, also adds to the jurisdiction's attractiveness. "It just ticks all the boxes for new fund products, including perhaps above all the fact that it is tried and tested among international institutional investors," she says.

"Luxembourg has positioned itself beautifully to take advantage of all the changes going on within Europe," agrees Burgess. "One of the reasons why Ocorian set up its business in Luxembourg in 2015 was because it is a nexus of activity and our clients were keen for us to have a presence there. That said, clients intending to set up new funds don't start by thinking they are going to set up a fund in a particular jurisdiction. The starting point is, 'Where is the best place to do business?' The Channel Islands, and Jersey in particular with its zero-tax rate approach to funds, are in a very robust place. Luxembourg is inside Europe and Jersey is outside, but they offer both political and fiscal stability in a very uncertain world."

It will be four years this summer since the introduction of AIFMD, and the directive requires that the European Commission should start a general review of its effectiveness by July 2017. As well as considering the potential granting of passports to non-EU-domiciled managers, the review could result in changes to other aspects of the existing regulation.

There is general agreement around the table that AIFMD was prompted by attempts to de-risk investment markets in general in the wake of the global financial crisis, rather than as a response to a specific problem within the real estate industry.

"AIFMD was particularly targeted at the hedge fund industry to deal with ultra-risk taking. Private equity and real estate funds were swept up at the same time. Our end of the market is lower risk and the need for these extra layers of regulation is less valued by investors," argues Burgess.

There is some debate, however, on whether the exercise has produced worthwhile results. Burgess is grudging: "A lot of my clients and their investors say AIFMD doesn't serve any beneficial purpose for them, but I can see that a badge of regulatory stability is important to some institutional investors."

Laming is more upbeat: "AIFMD is a reasonable set of standards that keeps bad actors out of the market and gives a lot of our investors a really strong set of rules that they can be really confident in. It has a halo effect. When all the AIFMD boxes are ticked they feel safe, and that is a really powerful brand. I would be upset if we lost that."

He would like a review of the directive to produce more clarity, but he is unaware of any signals being sent about likely

IPSX appeal

Will a proposed real estate investment exchange catch investors' imagination?

The International Property Securities Exchange (IPSX) is slated for a launch in mid-2017, subject to regulatory approval. Its backers claim it will be the first dedicated exchange to provide a public stock market solely for trading shares in companies owning and managing individual commercial property assets.

On the surface, the idea of allowing small investors to trade minority shares in large commercial buildings seems a good one, says Laming. "In principle, bringing assets into a securitized, transparent form with hopefully low transaction costs is great," he says.

The roundtablers identify several potential snags with the project, however. The spread between the price at which brokers are willing to buy IPSX securities and the price at which they are willing to sell could be high, cautions Laming. "What you never know with this sort of securitized product is who is going to be making the market," he says.

Burgess adds that he can see why IPSX would appeal to the big institutional investors. "If you own a large asset in the middle of London and you want to sell some of it down and redeploy the capital somewhere else, then it makes sense. Selling down 25-40 percent could be quite interesting from their perspective where they still control the asset."

However: "I think the running costs of one of these platforms will be expensive and we will end up seeing the discounts to net asset value that we see with UK REITs."

Laming and Burgess argue that high trading spreads leading to NAV discounts, together with the lack of control over the asset that comes with being in a minority position, and potential doubts over liquidity, could mean that IPSX securities have a limited attraction for institutional investors compared with conventional direct real estate investment.

"This is going to be more attractive to individual investors running their own SIPPs [self-invested personal pensions] who like the idea of having access to a piece of a commercial A-grade investment such as Tower 42 or Heron Tower [office towers in London] or similar assets," predicts Burgess.

changes. Baker would also like to see more precision in AIFMD's terminology. "It would be useful to have clarification on what constitutes 'marketing' because there are inconsistencies in the way it is operated at the moment, but I don't think there are any huge problems with it, so I would be surprised if there were any significant changes in AIFMD II," he says.

Burgess raises one misgiving, though. "There is a Brexit issue with AIFMD II. When AIFMD was developing, Britain – via Lord Hill's intervention as European Commissioner – was positive for the industry by introducing processes that ensured it was drawn up in a way that was as pragmatic as possible. Britain's diminished influence off the back of the Brexit vote should concern us all. As AIFMD II rolls on and that influence disappears or diminishes, the political instability that we are seeing in certain European states at the moment could result in adverse developments for AIFMD in the future," he warns.

The roundtable attendees view base erosion profit shifting (BEPS) as another regulatory area in which the real estate industry has been caught up as a collateral casualty. The OECD and G20 have introduced a package of regulations under which countries can collaborate to stamp out the practice wherein companies exploit mismatches in tax rules to shift profits to low-tax locations, despite the fact they have engaged in little substantial economic activity there. "We get caught up with the Googles and the Starbucks who were avoiding tax, whereas what the fund industry is doing is structuring to get investors to the same return position as if they were investing directly," complains Baker. "It is not shifting profits around so that they are taxed in a very low tax jurisdiction, but the headlines in national newspapers don't make that distinction. For them it is all tax avoidance. It is a very broad and swingeing set of rules that is going to apply to everybody and they are reluctant to make any exceptions."

Laming adds: "It is very unfortunate that real estate and other fund structures have been dragged into that, because the majority of investors we have in our funds are tax-exempt. Therefore, we are trying to replicate the same conditions they would have had on their own had they invested directly themselves."

So far Tristan's research on the subject has concluded that the impact of BEPS regulations on fund returns will be "pretty minimal." However, Laming is concerned by the unresolved question of how strictly the UK government will interpret BEPS provisions restricting the tax deductibility of corporate interest expense. "Interest deductibility across all structures and every single jurisdiction will have an impact. It is unquantifiable at the moment, but we are going to have to navigate it," he says. It is not yet clear what constitutes permanent establishment or substance in a country for tax purposes under BEPS, says Laming, so in the meantime Tristan is "playing it safe" by booking profits and making tax returns in many jurisdictions through a local branch or subsidiary.

BEPS is likely to result in greater tax transparency across the board, suggests Lyse. "A lot of our clients, both in private equity and real estate, are engaging actively in open and transparent conversations with local tax authorities about their current set-up," she says. "Typically, a real estate business pays tax wherever the assets are located, so it is not about tax avoidance, it is about paying the right amount of tax in a sustainable fashion, no more, no less. In the medium to long term we will likely end up in a situation where any fund manager should have a starting assumption that information related to their set-up, governance and the whole operating platform will be publicly available, at least to local and foreign tax authorities, if not to the wider public."

Laming: believes the large number of fund managers and insurers in London mean 'pragmatic politics will prevail' regarding Brexit

Liability mismatch

Another major regulatory change to impact the real estate market in recent years is Solvency II, which came into effect in January 2016. This harmonizes the regulation of the insurance industry across Europe with the aim of increasing the amount of capital that insurers hold to reduce the risk of insolvency.

High capital requirements on equity investment have encouraged insurers to enter the debt space, says Burgess. "The banks have stopped lending as much money and Solvency II has quite neatly filled the void resulting in insurance companies providing a source of real estate debt needed by the market, so they get the exposure to the big assets by lending against them when they probably would have owned them previously."

Laming argues that Solvency II, although well intentioned, could produce the opposite outcome to that originally intended. "It is a poorly timed piece of legislation. If they had done it 20 years ago, it would have been a stroke of genius. However, it has forced insurance companies down the risk curve at a time when the returns they require to meet their liabilities are as high as they have ever been. If your required return is greater than the return that the regulator forces you to make then there is a growing liability mismatch that could lead to financial issues," he says.

Laming adds that while Solvency II has made it more difficult for insurers to invest in real estate equity funds, some are taking advantage of flexibility in the application of the regulation to do so nonetheless. They create a 'proprietary internal model' under which the capital charges can be reduced, if they can show that the cumulative effect of investing in a number of funds reduces the overall degree of volatility across the portfolio.

Not everyone can take advantage of that flexibility, however. Lyse says: "Internal proprietary models only suit the largest insurers because they are highly complex and they take a lot of time and manpower to create and maintain. They also have to be validated by the national regulator. The smaller insurance companies often don't have that capacity, so most of the time they go for the standard model, which is generally significantly less favorable in terms of the solvency capital requirements."

Squeezing out the competition

The complexity and expense that comes with greater regulation favors the largest and best-established players in any market, contends Laming. Combined with the uncertainty of Brexit, he argues this has curbed the creation of new fund management firms: "Start-ups have no idea how to build a marketing team in the new post-referendum world, and before they step out of the door they will need several hundred thousand pounds of cash as regulatory capital and they haven't raised a penny yet because they are not approved. In the short run, AIFMD and Brexit are pretty much the death knell for smaller start-up managers."

He fears that could have a negative impact on competition and innovation in the sector. Tighter regulation was an inevitable consequence of the global financial crisis. In Europe, if not the US, authorities' desire to rein-in market excess and prevent the repeat of such an event remains strong. However, this table believes regulators must keep a keen focus on how the rules that they write play out in the real world if they are to avoid unintended and unfortunate consequences. □

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