FAMILY OFFICE PROPERTY INVESTMENT IN 2015

BEWARE THE NEW EU REGULATORY ENVIRONMENT

2014 saw the private wealth sector ramping up investment in the UK commercial property asset class to record levels. UK-based single family offices that would have invested in property directly, have been structuring their property investment via funds and need to take care that they are not caught by a range of post financial crisis regulations.

Rosalyn Breedy, a lawyer specialising in wealth management, explains that before the crisis it was fairly straightforward for a family office to determine whether or not its property investment activities were classed as a collective investment and consequently regulated. But now, under the current multi-layered regulatory regime, whether it is or is not a collective investment, a property fund may also need to comply with a raft of new regulations including FSMA, AIFMD, EMIR. Restrictions on financial promotion also remain relevant.

Market trends

Several industry commentators reported signs that investment in the UK property market was increasing in the final quarter of 2014:

- The UK Investment Management Association reported that property was the second best-selling sector in October 2014, ranking ahead of fixed income with net retail sales of £274 mn ;
- The M&G Investments Q3 2014 summary on UK property stated that " the asset class was supported by high demand from investors and a persistent lack of supply, as development activity remained limited"... "It now looks likely that total returns from property in 2014 will reach the highest levels seen for about eight years, ahead of both equity and fixed income markets in the UK."
- In December 2014, Property Funds World reported that according to DTZ Central London commercial property transactions reached GBP 2.9 billion in November, taking the year-to-date investment volume to GBP 15.4 billion.
- DTZ Research also show a record GBP 89 billion (US$ 142 bn) of capital (i.e. not only from funds) currently targeting European commercial real estate, of which a third (GBP 28 billion) is currently looking at the UK. They report "strong demand for core assets in the capital from both institutional and private investors."

Real estate private equity managers have also had a successful year in raising funds. Notably, Prequin's private equity database reported that in Q3 2014 the closed-end private real estate funds had a record

$220bn available to invest, up from $186bn in December 2013, representing the highest amount on record.

Of this, European funds have $66bn to invest. The increase in uncalled capital available to private real estate fund managers is as a result of strong fund raising over the last two years. The highest amount of capital was secured primarily by funds focused on Europe, with seven funds reaching an aggregate value of over US$ 10 billion.

Family office investment in UK property

Most private wealth investors will invest with institutional or private equity real estate funds, however, there has been a noticeable trend towards family offices investing directly.

Within single family offices, fund managers who have not researched the regulatory framework for a number of years are advised to take a fresh look to ensure that they do not ignore some of the new layers of protection for investors.

Where a family office is based outside the UK and EU, e.g. Guernsey, but markets into the UK, then they will still need to ensure that they comply with rules on financial promotions.

Rosalyn Breedy explores the most important regulatory issues a single family office operating will need to consider in regards to its property investments.

Financial Services and Markets Act 2000 (FSMA)

The first question to answer is whether the family office legal entity will be conducting regulated activities under the Financial Services and Markets Act 2000 (FSMA).

This is because unless a legal entity carrying out regulated activities by way of business in the UK is authorised by the Financial Conduct Authority or exempt from authorisation it will be breaching the general prohibition (FSMA s19). A breach could result in criminal penalties (including imprisonment) and investors being able to walk away from their obligations.

The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 sets out a list of specified activities which count as regulated when carried out in relation to specified investments, including:

- dealing in investments (as principal or agent);
- managing investments;
- safeguarding and administering investments;
- establishing, operating and winding up collective investment schemes;
- advising on investments; and
- agreeing to any of the above.

The list of specified investments does not include ‘property’ but does include amongst others, shares, instruments creating or acknowledging indebtedness, instruments giving entitlement to investments, certificates representing certain securities and units in collective investment schemes.

Families investing in commercial property indirectly need to ascertain whether or not they are carrying out regulated activities “by way of business” with a UK nexus, and if so whether they must be authorised, or whether their activities could be covered by one of a number of exclusions.

Alternative Investment Fund Managers Directive (AIFMD)

In particular, the family office will need to determine whether it is carrying out a new regulated activity of “managing an alternative investment fund”. This was introduced as part of the UK’s recent implementation of the Alternative Investment Fund Managers Directive (AIFMD), which regulates the managers of alternative investment funds. The directive sets out rules about their authorisation, ongoing operation, transparency and reporting obligations including:

- Article 6(1), which states that “Member states shall ensure that no alternative investment fund managers manage alternative investment funds unless they are authorised in accordance with this Directive”; and
- Article 7(1), which goes on to state that “Member states shall require that alternative investment fund managers apply for authorisation from the competent authorities of their home Member State.”

The family office needs to consider the following factors:

- Does it appear to manage an “alternative investment fund”, defined as a collective investment undertaking that raises capital with a view to investing it in accordance with a defined investment policy for the benefit of its investors and which does not require authorisation under the UCITS IV Directive?
- If the fund does not raise capital from third parties, it may escape the definition by virtue of a recital to the directive that deals specifically with family investment vehicles.
- If the office does seem to manage an alternative investment fund, however, is the “manager” as defined by AIFMD itself – i.e. does the family office carry out “portfolio and risk management responsibilities” – or should another entity in its structure chart be regarded as the manager?
- Either way, does the manager carry out its activity “by way of business”?
- Does the activity have a significant enough UK nexus to be caught by FSMA?
- If these things are the case, does an exclusion apply?

European Market Infrastructure Regulation (EMIR)

Interest rate swaps are commonly used to finance investment in real estate, and where these are used, a family office will need to have regard to the European Market Infrastructure Regulation (“EMIR”).

EMIR aims to increase stability in over-the-counter derivative markets throughout the EU. It stems from the G20's commitment to mandatory clearing and reporting and aims to standardise clearing of over-the-counter derivatives through central counterparties and reporting to trade repositories.

Among others, alternative investment funds whose managers are authorised or registered under AIFMD are categorised by EMIR as financial counterparties who, like banks and swap dealers, will be required to clear interest rate swaps through central counterparties.

The family office will need to confirm whether they are categorised as a financial or non-financial counterparty – most single family offices should fall into the latter category if they are not an alternative investment fund manager under AIFMD. This is because for financial counterparties, contracts not cleared through a clearing counterparty will be subject to bilateral collateral requirements. Non-financial counterparties will have lesser responsibilities provided their overall derivative exposure is below a fairly substantial threshold and their derivative activity is not because they are engaging in reducing commercial risk or related to treasury activity.

These sub-threshold Non–financial counterparties have responsibilities for reporting, and 'alternative' risk mitigation and typically these can be delegated to the swap counterparty, assuming the counterparty is a financial counterparty. Family offices outside the UK trading with banks within the EU may still be subject to some obligations.

FSMA Restriction on Financial Promotions

Finally, family offices also need to be aware of the restrictions on financial promotion in the UK.

FSMA provides that a person must not in the course of business, communicate an invitation or inducement to engage in investment activity unless the promotion has been made or approved by an authorised or exempt person.

Engaging in investment activity is defined as doing one of the following:

- entering or offering to enter into an agreement the making or performance of which by either party constitutes a controlled activity (these are listed in a statutory instrument); or
- exercising any rights conferred by a controlled investment (also listed) to acquire, dispose of, underwrite or convert a controlled investment.

Again, although property itself is not specified as a "controlled investment", units in collective investment schemes and shares are.

It is a criminal offence for an unauthorised person to communicate a financial promotion unlawfully (i.e. other than in compliance with the rules or exemptions) and this could result in a fine or up to two years imprisonment.

In addition, agreements entered into by investors as a result of unlawful financial promotions are unenforceable against those investors.

There are exemptions to the financial promotion restrictions for unauthorised persons; however, their correct application is not straightforward.

It is also important for family offices to understand that where an alternative investment fund is concerned there are different rules following implementation of AIFMD concerning its marketing which have to work in tandem with the rules on financial promotions.

When a family office manages and markets an alternative investment fund then, unless it benefits from an EU marketing passport under AIFMD, it will need to comply with national AIFMD private placement rules.

M&G investments conclude that "While the pace of returns may slow in the coming years, the background remains favourable for property investment". And whilst single family offices seek to share in these returns, they also need to take care to tread carefully in the new regulatory regime. An unplanned encounter with the Financial Conduct Authority on the subject of non-compliance can take the shine off the brightest of investment prospects.

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Author

Rosalyn Breedy, Partner
+44 (0)20 7863 8547
rosalyn.breedy@forsters.co.uk