Real Estate:UK response to FCA 26/16 Registration of authorised fund assets

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Real Estate:UK

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General Comments

We would like to thank the FCA for engaging with RE:UK members during the consultation period and allowing addition time for RE:UK to respond to the consultation.

We support the FCA's aims to address the concerns of depositaries being exposed to 'ancillary' legal, reputational and financial risks, especially in areas like UK commercial real estate. As acknowledged in the consultation paper, new laws impose potential criminal and financial liabilities on legal owners and their staff. As depositaries do not manage the assets or make the decision to invest in them, they are not willing to take these additional risks on. However, as we explain below, we believe the proposed solution is not ideal and should be considered as a temporary solution.

We appreciate that the FCA will only take forward the proposed solution if they are sure AFM's affiliates are willing to take on the registration function and the associated risks. Our AFM members have not confirmed this either way to us. They are very concerned with the increased operational burden on AFMs such as the cost of registering legal title to the AFM affiliate, holding titles to the depositary and having to explain within their firms and to other parties to transactions why the title is in the name of the AFM affiliate. We would suggest once the feedback to the consultation has been considered by the FCA and any changes to the proposals made, at that stage the FCA confers with the AFMs direct whether any proposed FCA solution is workable from the AFM perspective.

Long-term solution

The FCA has correctly identified a regulatory failure caused by the current rules being outdated and poorly suited to the growth in private markets. However, the proposed solution in CP26/16 is just putting a sticking plaster on the problem rather than solving it properly. The proper solution involves amending primary legislation, and Government delivering speedily on this: not just working within the restraints of the current Financial Services and Markets Act 2000 (FSMA) and its secondary legislation (principally the OEIC Regulations 2001.

The Government and the FCA must, as a priority, modernise and reform legislation and regulations for the long-term. There should be changes to FSMA, the OEIC Regulations and COLL to enable a more efficient, cost-effectively and workable solution. This would enable AFMs of authorised property funds (PAIF/AUT/CoACS) to provide competitive products for retail clients to invest in real estate. We propose new FCA regulations should utilise concepts already embedded in primary legislation such as Law of Property Act 1925 sections 2 and 27; and FSMA Section 235A(3)(d). From a policy perspective, we believe that market participants should be able to adopt solutions that fit efficiently and cost-effectively. FCA regulations and other legislation should be expressed as principle-based, be more flexible, less prescriptive and future proofed: for example, accommodate market and legislative changes.

We recognise that in practice there are various main structures in the market, with some having legal personalities and some not:

- Property Authorised Investment Fund (PAIF), which operates as an OEIC/ICVC, has legal personality.
- Authorised Unit Trust (AUT) does not have legal personality.
- Co-ownership Authorised Contractual Scheme (CoACS) does not have legal personality. [By way of context, the unauthorised contractual scheme/RIF and English Limited Partnership also do not have legal personality.]

in relation to having or not having legal personality, we believe that the depositary's role can be more than adequately protected by way of restrictions at the Land Registry that prohibit any dealing without the prior written consent of the depositary.

One of our Legal Members conferred with its network of EEA law firms and produced the information in Annex 1 on a goodwill and no-advisory basis. This reinforces our requests that:

- The PAIF (operating as an OEIC/ICVC: which has its own separate legal personality) should be entitled to hold legal title in its own name (or via two nominee companies) combined with Land Registry restrictions that prohibit any dealing without the prior written consent of the depositary.

- There should be a different treatment, as shown in Annex 2, in the case of structures that do not have separate legal personality: AUT and CoACS.

In Annex 2 to our response, we illustrate how AFMs of authorised funds (CoACS/AUT/PAIF) can efficiently and cost-effectively operate, and hence in a workable manner with the depositary's role adequately protected by way of restrictions at the Land Registry.

Annex 2 contains an observation that, for AUTs and CoACS, a bare trust does not trigger CASS, and that a bare trustee who is not an FCA-authorised firm performing a regulated activity is outside CASS. It would be helpful if this is reflected in the FCA's Policy Statement, in order to address any potential regulatory uncertainty.

The bare trust solution should be useful to address the issue mentioned in paragraph 2.26 of the consultation paper related to the AFM's insolvency and impact on "the integrity of the fund's property interests in its assets, or cause a delay in accessing them". We endorse "the principle of separation of AFM and depositary duties".

In the case of a depositary being replaced, having the restrictions at the Land Registry would still enable this to happen efficiently and smoothly without impediments (including changing the registered proprietors at the Land Registry and associated costs having to be incurred like legal and Land Registry fees).

Contractual Schemes

In relation to contractual schemes, there should be consistency of approach between authorised contractual scheme, CoACS, and unauthorised contractual scheme, RIF. The consistency of approach may facilitate conversions: CoACS to RIF or RIF to CoACS. A conversion of a RIF into a CoACS is treated as an exit from the RIF regime, and HMRC provides specific statutory tax neutrality for that conversion, with UK tax exempt investors incurring no dry tax charge arises on the conversion.

Disapplying the requirement for the depositary to hold legal title

In relation to the PAIF and OEIC Regs 2001 s.5(2)(a), (the FCA may disapply the requirement for the depositary to hold legal title) we take the view that s.5(2)(a) provides a narrow and controlled flexibility: it allows the FCA to remove only the requirement for the depositary to hold legal title, while leaving the full safeguarding and oversight framework intact. This means the FCA can eliminate legal title risk without weakening investor protection i.e. the depositary remains fully responsible for safekeeping, cash flow monitoring, and oversight under COLL, exactly as before. S.5(2)(a) enables a modernised operational model that preserves all core regulatory duties while allowing title to sit with the most efficient or appropriate entity, ensuring continuity of protection for investors and maintaining the integrity of the authorised fund regime. s.5(2)(a),OEIC Regs 2001 removes a method of compliance, not the obligation itself. We would like the FCA to revisit their interpretation of this rule.

UK AIFM Regime

We note the recently published HM Treasury's policy paper on the Draft legislation to reform the regulatory framework for Alternative Investment Fund managers and the FCA's consultation paper on the UK AIFM (CP26/28). We welcome the policy direction of the forthcoming UK AIFM Regulations 'repeal and replace' to ease the need for UK AIFMs to engage depositaries. We suggest that any FCA policy arising from CP26/16 should be consistent with that policy direction. We endorse FCA policy goals to protect customers and to ensure that UK firms can operate efficiently, cost effectively and hence have a workable operating model. Also, at the same time, minimising scope for harms including conflicts.

Depositary Oversight

Our AFM Members have expressed concerns that depositaries are in practice increasingly impeding fund operations including when property transactions are being undertaken by the funds. There is “depositary creep”: when, from a regulatory perspective, the depositaries should have an ultimate control, direction and safeguarding role, depositaries are in practice (and unjustifiably) insisting they have must have a day-to-day control, direction and safeguarding role. This is resulting in increasing their workstreams and fees, and slowing down property transactions. We appreciate some of this may be due to the additional risks to depositaries under the current legislation. However, we are not convinced this will be rowed back on if depositaries are permitted to delegate their registration function to AFM affiliates. The FCA should clearly outline exactly what responsibilities remain with the depositary following depositary delegation proposed under Chapter 3 of the consultation paper, and why.

Clarification of "held to the order of"

We ask the FCA to clarify its understanding of “*the property subject to the scheme is held to the order of a depositary*” in FSMA Section 235A(3)(d), as an alternative to “*the property subject to the scheme is held by a depositary*” also in FSMA Section 235A(3)(d).

We would like the FCA to clarify, with worked examples in a Policy Statement, its understanding of "*held to the order of a depositary*" under FSMA Section 235A(3)(d). We assume this may apply in a revised COLL 6.6.15R (4B)(e) (see our response to Question 13), Also, it should be confirmed that the depositary, in that scenario, does not need to hold legal title; but needs to have ultimate (i.e. not day-to-day) control, direction and safeguarding authority over the scheme property.

By way of context in an unauthorised fund scenario that involves an English Limited Partnership (which does not have legal personality) with a General Partner (“GP” - which has legal personality), then the GP and a nominee company (owned by the GP/AIFM) (or two nominees owned by the GP/AIFM) typically hold the assets on behalf of the English Limited Partnership. The depositary retains power to issue binding directions on dealings relating to the underlying property, and the GP/AIFM unable to sell or pledge the property as security without the active involvement of the depositary.

Drafting concern

As a matter of drafting, we question the proposed wording for COLL 6.6.15R (4B) (e):

> "*The person must hold the scheme property on trust for the depositary* ....".

This would result in the depositary becoming the beneficial owner of the scheme property for tax purposes (which surely is not the intention). We suggest the wording is revised to:

> "T*he person must hold the scheme property to the order of the depositary* ...."

This is consistent with FSMA Section 235A(3)(d) that applies to the CoACS and the RIF.

"*On trust for the depositary*" creates a true bare trust: the depositary becomes the beneficial owner. "*To the order of the depositary*" creates a custodial/nominee control obligation: the depositary has directional control, but not beneficial ownership. They are not the same: the first changes the ownership structure whereas the second changes only control.

Key concepts

We ask that the Policy Statement should be clear on any key concepts, specifically "delegation" and "affiliates" as referenced in CP26/16, and at re-engage with stakeholders if these concepts were proposed to be taken forward.

Response to consultation

We have responded, where we can, to the consultation questions below.

Authorised AIFs with small UK AIFMs: proposal to align the COLL registration function rules in respect of assets that are not safe custody investments or AIF custodial assets

Question 1 **Do you agree that we should allow the depositary of an authorised AIF managed by a full-scope UK AIFM the option of delegating its COLL registration function and CASS 6 custody function for assets that are not AIF custodial assets?**

We support the proposal to allow the depositary of an authorised AIF managed by a full-scope UK AIFM the option of delegating its COLL registration function and CASS 6 custody function for assets that are not AIF custodial assets.

Question 2 **Do you agree that the persons able to act as the delegate of a depositary of an authorised AIF managed by a full scope UK AIFM, for its COLL registration function in respect of assets that are not safe custody investments or AIF custodial assets, should only be 'affiliates' of the AFM?**

We understand why the FCA is proposing that affiliates of the AFM act as the delegates of depositary. However, as we have explained in the General Comments above, this is just putting a sticking plaster on the problem rather than solving it properly. The Government and the FCA must deliver speedily on legislative reform. Priority should be given to implement changes to FSMA, the OEIC Regulations and COLL, and facilitate a more efficient, cost-effectively and long-term workable solution. This would enable AFMs of authorised property funds (PAIF/AUT/CoACS) to provide competitive products for retail clients to invest in real estate.

Question 3 **Do you agree with our proposed additional protections, to apply when the depositary of authorised AIF managed by a full-scope UK AIFM delegates its COLL registration function in respect of assets that are not safe custody investments or AIF custodial assets to the AFM's affiliates?**

We would suggest the FCA confers directly with AFMs on the specific additional protections. We are concerned that the current FCA proposals could lead to additional significant costs that could result in the AFMs questioning the operational viability of operating authorised property funds.

As mentioned in our General Comments above, our AFM Members have raised concerns that the oversight requirements being demanded by depositaries are already delaying day to day operations including property transactions. The proposed additional operational requirements proposed by the FCA will only exacerbate the operational burden.

Question 4 **Do you agree that in the case of immovables located in the UK, the persons able to act as the delegate of the depositary of an authorised AIF managed by a full scope UK AIFM, for its COLL registration function, should only be 'affiliates' of the AFM that also take the form of a UK company subject to the Companies Act 2006?**

Yes agreed, though recognising that any property holding must be via two nominee companies and a bare trust arrangement applying Law of Property Act 1925 sections 2 and 27.

Question 5 **Do you have any feedback on matters relevant for UK property overreaching?**

The UK property overreaching principle must apply: any property holding via two nominee companies and a bare trust arrangement applying Law of Property Act 1925 sections 2 and 27.

Authorised AIFs with small UK AIFMs: proposal to align the COLL registration function rules in respect of assets that are not safe custody investments or AIF custodial assets

Question 6 **Do you agree with our proposed changes to the COLL registration function requirements for depositaries of authorised AIFs managed by small UK AIFMs, in respect of assets that are neither safe custody investments nor AIF custodial assets?**

We note the proposed Annex B Amendments to COLL 6.6.15R (4B) (a) – (h) inclusive. We have received no feedback from our members on this. We suggest that the FCA engages with AFMs individually on whether these provisions are workable.

Depositaries of UK UCITS funds

Question 7 **Do you agree with a rule change preventing a UCITS AFM from acting as a delegate for the depositary for any task?**

N/A

Question 8 **Do you have any other feedback on COLL registration function (or custody) issues for UCITS funds?**

N/A

Proposed clarificatory changes for the COLL registration function rules

Question 9 **Do you agree with our proposed re-drafting of the COLL registration function rules and the new guidance which aim to clarify their requirements in respect of assets that are neither safe custody investments nor AIF custodial assets?**

No comment

Question 10 **Do you agree with our proposed change to the COLL registration function rules that, for safe custody investments, the depositary can only have the assets registered in its own name in the case of partnerships that are a CIS but that are not AIF or UCITS custodial assets?**

No comment

Proposed clarificatory CASS 6 changes

Question 11 **Do you agree with our interpretation of CASS 6's application to UCITS and AIF depositaries as set out in this CP and do you agree with our proposed CASS 6 rules changes and new guidance?**

No comment

Question 12 **Do you think any of these proposed CASS 6 rules changes and new guidance could create unintended consequences that would negatively impact the protection of client assets?**

No comment

Overall timing and sequencing considerations

Question 13 **Do you agree that, should feedback indicate that our objectives would be advanced by the rule changes in this CP, we should proceed to make them at the earliest opportunity, and before any later changes that may stem from our planned broader review of depositary rules?**

We appreciate the desire to proceed with the proposed rule changes at the earliest opportunity to address the legislative risks faced by depositaries. However, as we have mentioned earlier in our response, the FCA and Government should be working together and prioritising modernised and reformed legislation and regulations. The Government should be looking to amend primary legislation, and deliver this speedily, rather than expecting the FCA to work within the restraints of the current legislation. To be competitive with other European jurisdictions the UK should have a solution where the assets can be held by the fund where it has legal personality or by the AFM (via two nominee companies), with the depositary's interest being noted at Land Registry.

This would mean the depositary's permission would be required for any property transactions. The UK must learn from how other jurisdictions and put in place the best practices.

As we have mentioned in our General Comments above, we believe the following proposed wording for COLL 6.6.15R (4B) (e) would result in the depositary becoming the beneficial owner of the scheme property for tax purposes:

"*The person must hold the scheme property on trust for the depositary ….*".

We assume this is not the intention, and therefore suggest the words are revised to:

"*The person must hold the scheme property to the order of the depositary ….*"

This is consistent with FSMA Section 235A(3)(d) that applies to the CoACS and the RIF "*On trust for the depositary*" creates a true bare trust: the depositary becomes the beneficial owner. "*To the order of the depositary*" creates a custodial/nominee control obligation: the depositary has directional control, but not beneficial ownership. They are not the same: the first changes the ownership structure whereas the second changes only control.

Replacing a Modification by Consent

Question 14 **Do you agree that we should replace the Modification by Consent for COLL 5.6.22R with permanent rule changes?**

We support the proposal to replace the modification to COLL 5.5.22R with a permanent rule change, enabling the NURS depositary for the account of the fund, or the NURS ICVC (OEIC), to provide guarantees and indemnities backed by scheme property to third parties where required by the terms of the purchase of immovable property for the fund.

End of response

Annex 1

Assessment: Sample EEA Jurisdictions – EU AIFMD: AIFs and holding domestic real estate title

This information has been provided on a goodwill basis and must not be considered as legal advice.

In each of the jurisdictions below, the circumstances vary in terms of fund structures and legal/non-legal personalities. We note that Austria has addressed funds without legal personality. In Denmark there is an obligation on the depositary to verify ownership, not to hold ownership. The Irish solution has adopted a pragmatic approach in terms of the Land Registry – which, as a common law jurisdiction, may have useful parallels to England, Northern Ireland and Wales.

Austria

The Real Estate Investment Fund Act (ImmoInvFG) governs open-ended real estate funds (in practice, all open-ended real estate funds use this form). These AIF do not have legal personality but are segregated pools of assets (managed by the AIFM). The depositary is not required to hold legal title to the fund's real estate. The statute rather expressly provides that the assets are owned by the AIFM, which holds and manages them on a fiduciary basis for the investors (thus, they are not affected by an insolvency of the AIFM). The depositary's role is limited to custody of financial assets, maintenance of accounts, and ongoing monitoring of the fund's assets.

Other real estate funds are governed by the Austrian Alternative Investment Fund Managers Act (AIFMG, which implements EU AIFMD). According to the AIFMG, the depositary likewise does not acquire legal title to real estate assets. For non-custodiable assets such as real estate, its function is to verify, document and monitor ownership and maintain appropriate records. The AIFMG contemplates that ownership may rest with the AIF itself or with the AIFM (or another person) acting on behalf of the AIF, depending on the fund structure.

Denmark

The depositary should not be listed as the owner of a property fund's properties. In Denmark, it is the AIF (though in practice this is typically a holding company owned by the AIF) that is listed as the owner of the properties. If the depositary were to be listed as the owner, this would also cause problems with registration fees and so on should the depositary need to be replaced.

In principle, there are some types of Danish funds without separate legal personality, and for these, the AIFM would, in principle, have to be listed as the owner of directly held property. However, these types of funds are not usually used in Denmark.
The depositary's role in Denmark, in relation to the ownership of property, will therefore primarily be to verify the fund's ownership of the relevant property or properties – not to be listed as the owner.

The Danish Financial Supervisory Authority has issued guidance, which also states that property falls under the category of "other assets" [non-custodial], where the depositary is not required to hold the asset in custody and therefore does not need to be registered as the owner: *Guidance on depositaries for alternative investment funds.*

With regard to other assets (which, according to the guidance, include, for example, real estate), the following is stated, amongst other things: "As the assets, by their very nature, are not held in custody by the depositary, the depositary's main tasks are to verify and register, respectively, the alternative investment fund's ownership of the assets. Verification must be based on the available written documentation, which is provided either by the alternative investment fund or its manager, and on any existing external documentation that may be available."

Germany

For closed-ended real estate funds structured as a partnership it is definitely the fund who holds the title in any real estate. For open-ended Sondervermögen (contractual arrangements), the AIFM holds title (in escrow for the investors).

Ireland

The fund (or the AIFM on its behalf) holds title rather than the depositary. However, there are some protective rules around this. The fund is required to (i) put a restriction on the title to the effect that title cannot be disposed of without the prior consent of the depositary or (ii) put a caution on the title (under which they are required to give notice to the depositary of a proposed dealing involving the real estate/to warn prospective purchases that the prior consent of the depositary is needed).

Norway

The fund itself holds title to the fund's real estate, not the depositary or the AIFM. In Norway, real estate is always held through an intermediate SPV - a private limited company (aksjeselskap) - which is owned directly by the fund. As a consequence of this structure, the depositary does not hold or safe-keep the real estate directly. Instead, the depositary safe-keeps the shares in the SPV, which constitute financial instruments for the purposes of EU AIFMD.