The pressure for global corporate governance standards for the real estate investment management industry

Keynote presentation to the RICS and SPR "Cutting Edge" Conference 2013

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Introduction

Background

The starting point for this paper presented to the Royal Institute of Chartered Surveyors and Society of Property Researchers "Cutting Edge" Conference on 22nd October 2013 was an earlier report for the Association of Real Estate Funds (AREF), "Unlisted funds - lessons from the crisis"* published in January 2012.

Report for AREF

The five years up to the start of 2012 were a period of unprecedented turbulence for the real estate funds industry. AREF asked John Forbes of PwC to undertake a study of the behaviour and practices of its member funds in dealing with consequences of this. Despite the unique level of stress to which they have been exposed, both the open-ended and closed-ended fund models in the United Kingdom largely weathered the storm. However, the clear perception among both fund managers and investors interviewed was that some funds and managers weathered the storm better than others, and that the full consequences of the crisis had yet to play out.

Transparency between fund managers and investors is crucial to the continued prosperity of the real estate fund management industry.

The report for AREF concluded that is important that there is a continuing dialogue between fund managers and investors. Many interviewed expressed the concern that the collective memory in the industry might be short. A continuing dialogue and debate on these matters will hopefully ensure that this is not the case. .Although a more demanding investor base represents a threat for some fund managers, it represents an opportunity for others. Those who manage to rise to the challenges in respect of transparency and governance will differentiate themselves, as will managers who focus on product development to create innovative funds. The aftermath of the period of volatility represents a unique opportunity for product development.

AREF has continued to maintain this dialogue since the publication of the report, as have other industry bodies. INREV, the organisation representing institutional investors is also updating its guidelines.

This conference paper seeks also to contribute to this dialogue.

*Report by PwC for the Association of Real Estate Funds, "Unlisted funds - lessons from the crisis", written by PwC partner John Forbes http://www.johnforbesconsulting.co.uk/aref-report

This conference paper

Real estate has become an increasingly global and cross-border business in recent years. However the global financial crisis exposed a number of weaknesses in the open and closed-ended fund model as well as short-comings in the industry in respect of governance, transparency, communication with investors, risk management and controls environment.

The paper looks at the impact that the changed attitude and approach of key stakeholders is having, in particular:

a). Investment consultants providing advice to clients as to which fund managers with whom to invest, in the process weeding out those who fail to reach an acceptable standard;

b). Multi-managers and fund of fund managers standardising their requirements for the funds in which they invest internationally;

c). Institutional investors including sovereign wealth funds becoming more stringent in their requirements for fund investments and for joint ventures;

d) Large global funds, in particular in the opportunistic area using a model where much of their investment is via joint ventures with local operating partners.

This has been investigated through interviews conducted with a cross section of investors, consultants, fund managers and placement agents. The results of this are set out on pages 47 to 58.

This paper also looks at two other key areas:

a). Regulatory change, in particular the European Union Alternative Investment Fund Managers Directive is setting a minimum standard for funds managed in the EU and for funds marketed to EU investors. This section, covered briefly on pages 33 to 36 is taken from a presentation to the Real Estate Investor Forum in London on 18th September 2013 entitled, "The rock of Sisyphus" Facing the burden of regulation. The full slide pack from this presentation is available on http://www.johnforbesconsulting.co.uk/real-estate-investor-forum

b). The role of auditors, particularly through the adoption of the international standard ISAE 3402 for independent audit of controls environment and more generally the standardisation of international accounting and reporting (IFRS).

The slides for the presentation of the findings as a keynote presentation to the Royal Institution of Chartered Surveyors and Society of Property Researchers "Cutting Edge" Conference on 22nd October 2013 are set out on pages 5 to 42 with notes on pages 43 to 46.

The starting point
A changed environment for the industry

Investor pressure

Improved governance

Greater transparency

Stronger controls environment

More independent supervision

Regulatory pressure

DIRECTIVE 2011/61/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL
of 8 June 2011
on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC

This report

Background

- Real estate investment management is becoming more global;
- Real estate investment management is becoming more complex;
- Real estate investment management is becoming more regulated;
- Real estate investment management is becoming more professional;

This report

The thesis

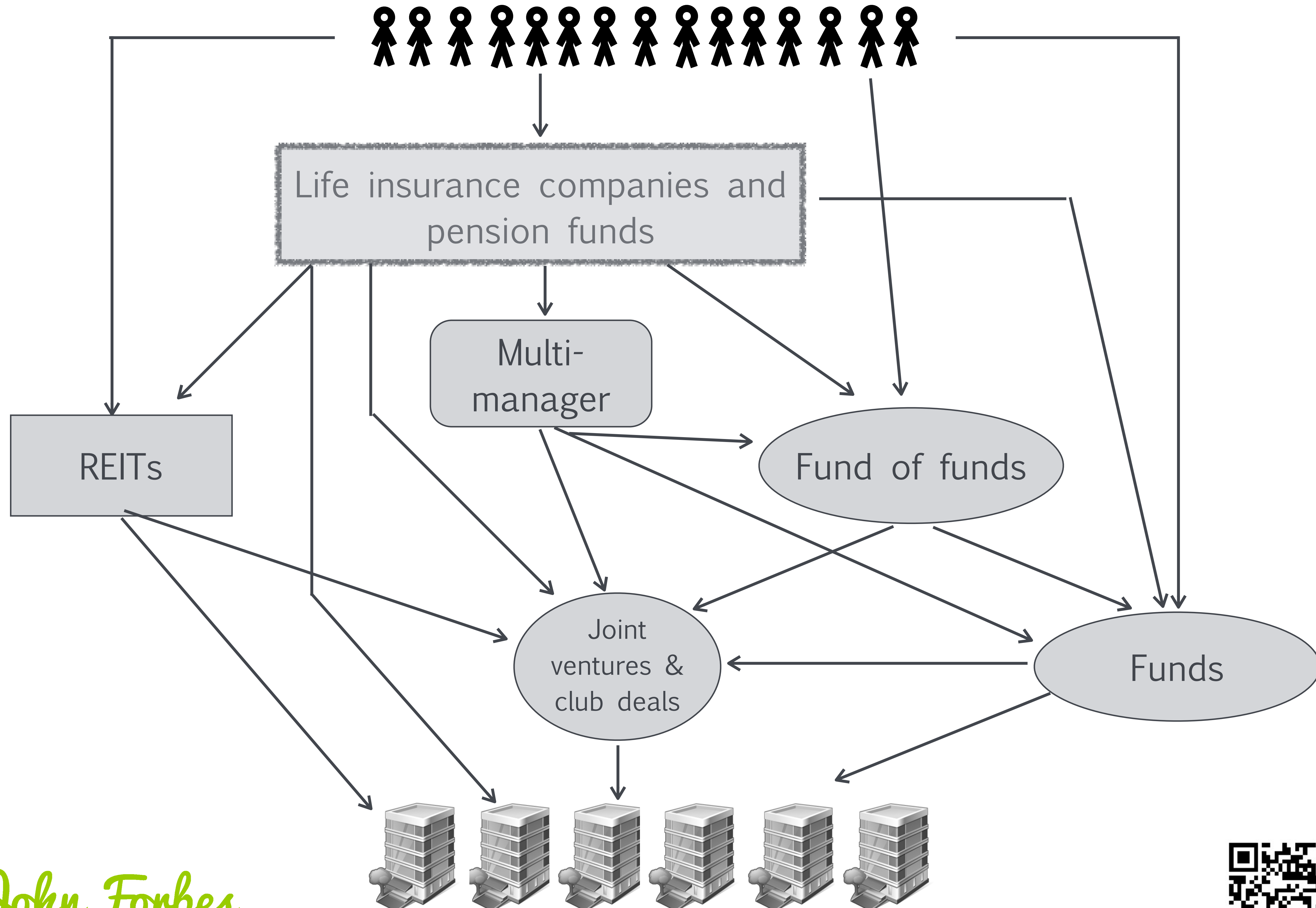
The global financial crisis exposed a number of weaknesses in the open and closed-ended fund model as well as short-comings in the industry in respect of governance, transparency, communication with investors, risk management and controls environment. International investors, regulators and standard-setters are driving change.

The test

- Interviews with investors, consultants, managers and placement agents.

- Regulations, standards and examples.

How we invest in real estate to provide for retirement



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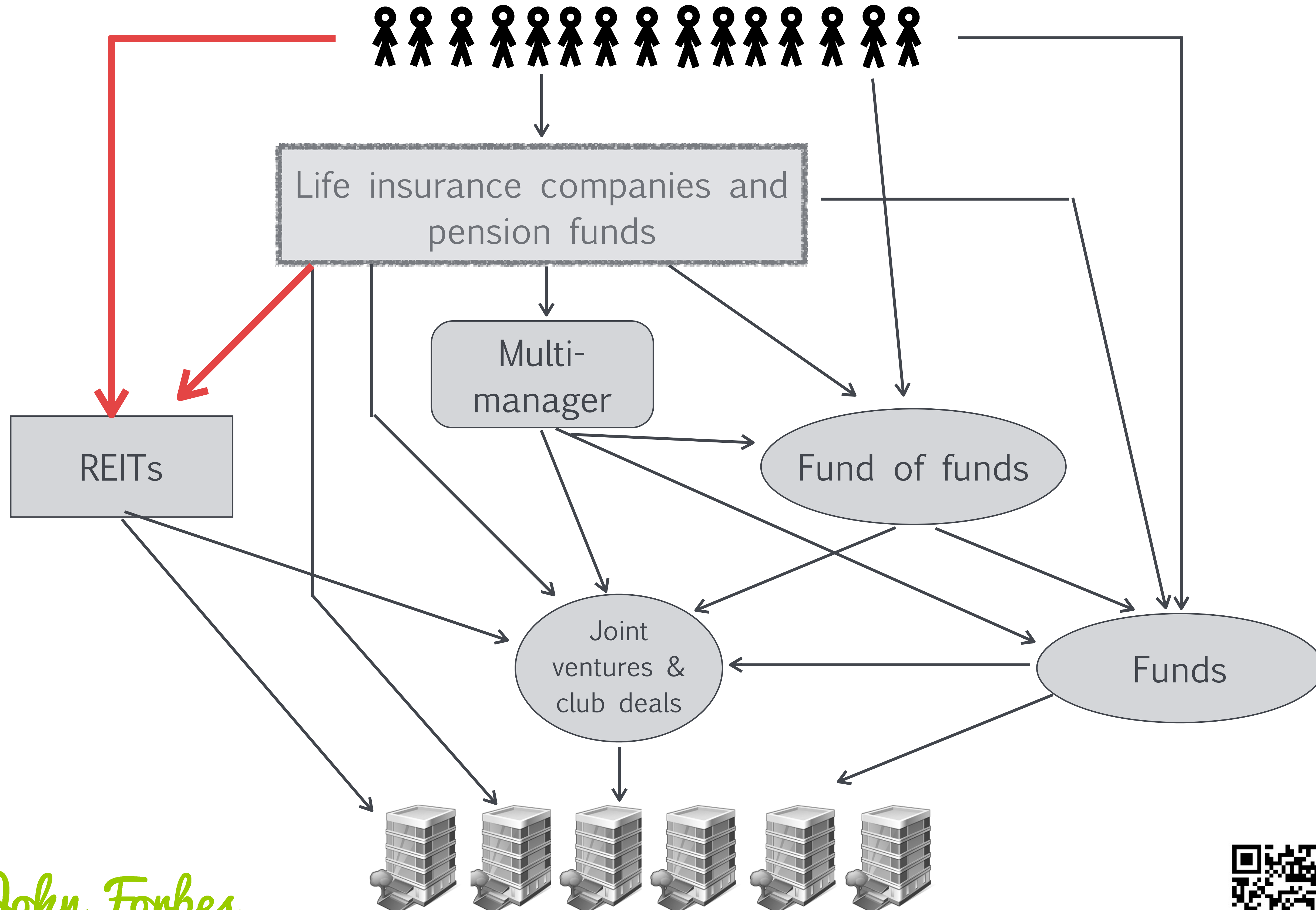
How we invest in real estate to provide for retirement



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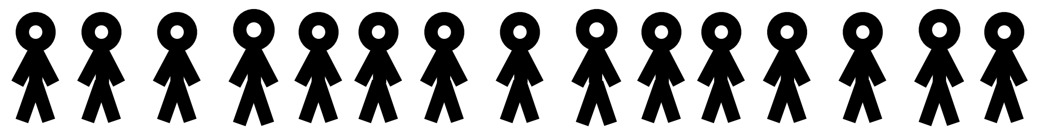
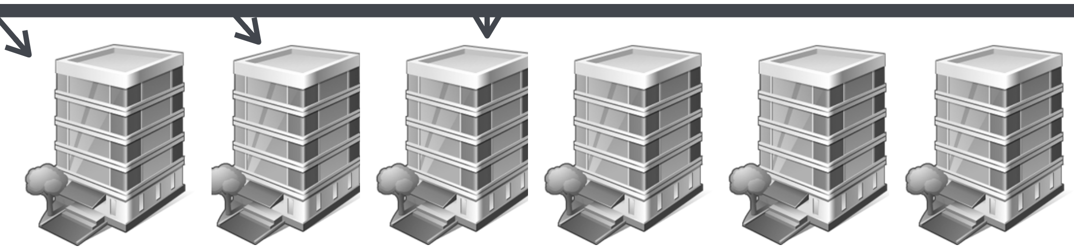
How we invest in real estate to provide for retirement



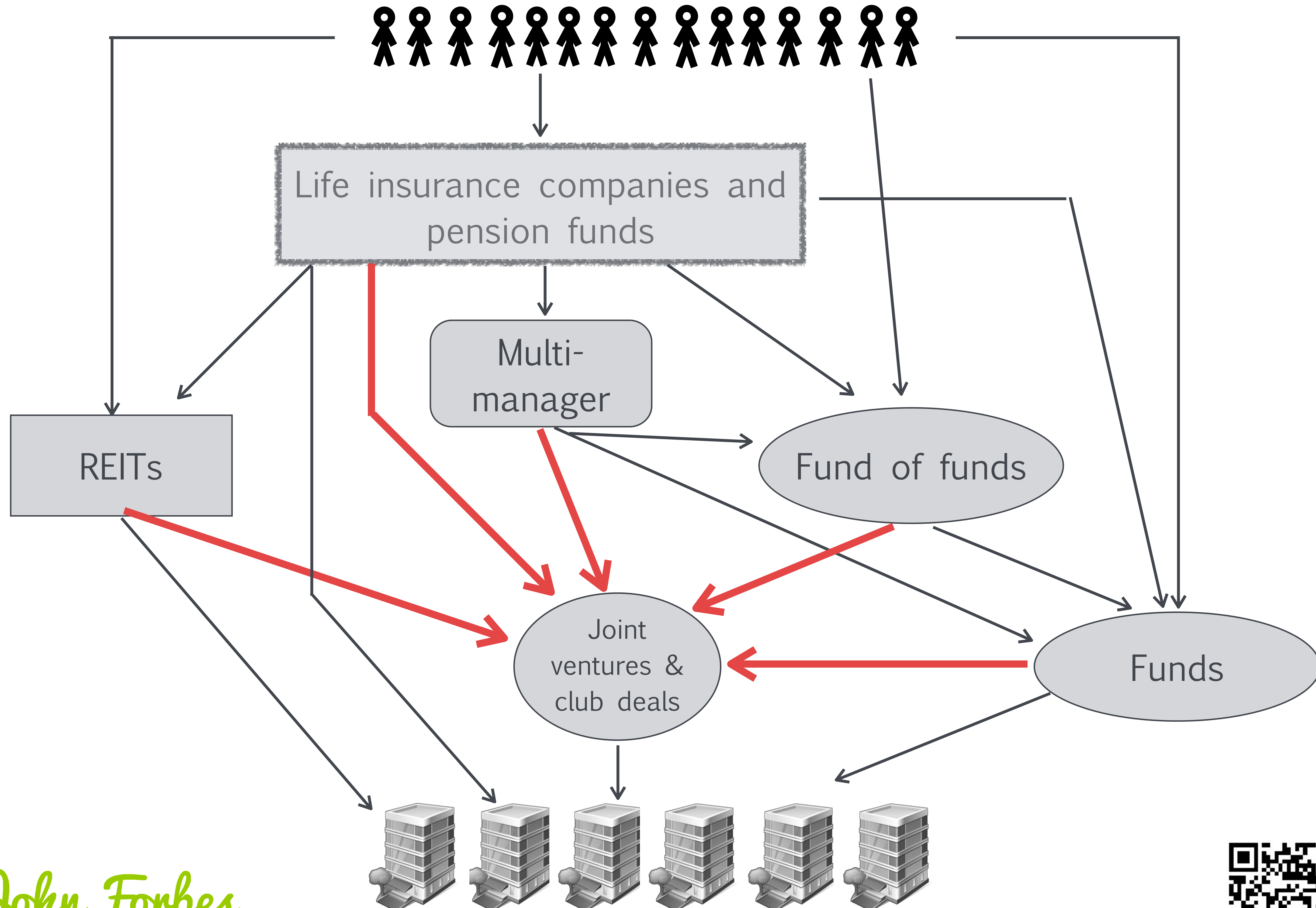
Life insurance companies and

REITs

- Stock exchange listing requirements impose governance standards;
- Funds need to raise standards to match REITs;
- UK September 2012 Corporate Governance Code
- Companies from one territory listing in another result in an export of standards - eg overseas companies with London main market listing.



How we invest in real estate to provide for retirement



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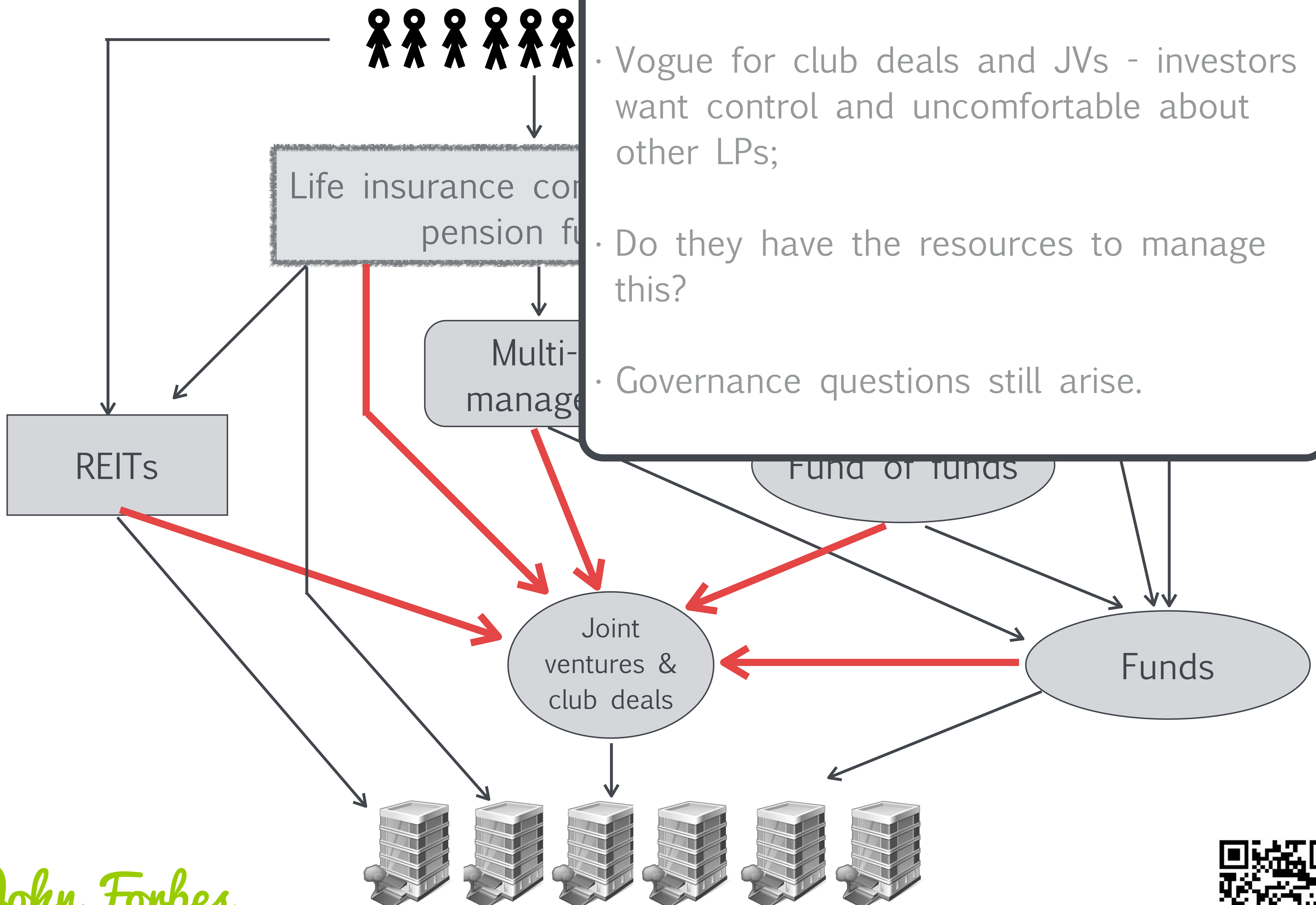
How we invest in real estate to provide for retirement



- Vogue for club deals and JVs - investors want control and uncomfortable about other LPs;
- Do they have the resources to manage this?
- Governance questions still arise.

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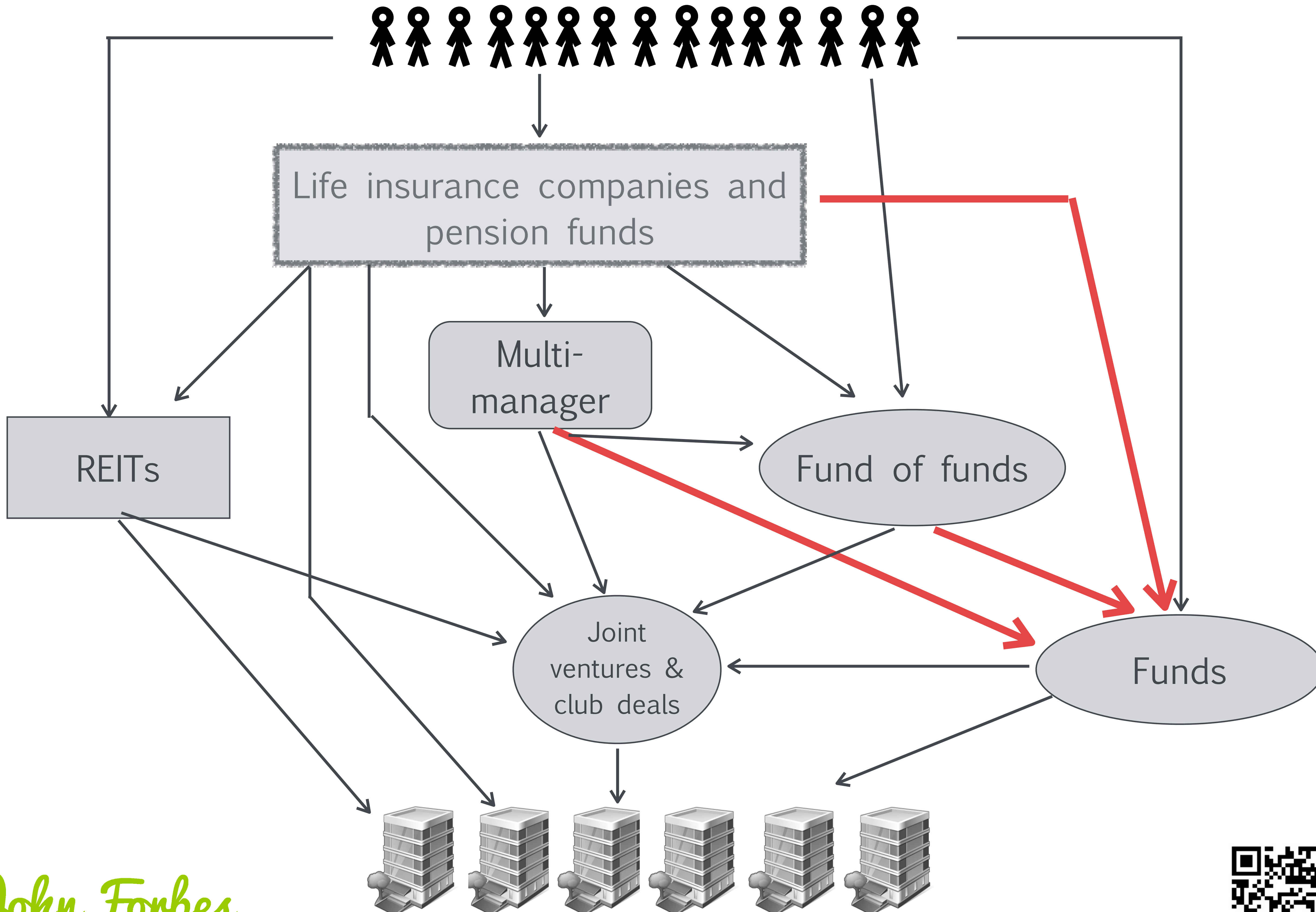
How we invest in real estate to provide for retirement



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What did those interviewed say?

- The increasing demands of due diligence
- Understanding operational aspects of JV partners and fund managers;
- Methodology - standardisation versus intuition;
- Use of industry standards (eg INREV due diligence questionnaire);
- Controls environment and the impact of anti-corruption legislation;
- The availability of in-house resources and outsourcing;
- The impact of under-resourced investors;
- Independent supervisory boards and investor advisory committees;

What did those interviewed say?

- Transparency and ongoing reporting;
- Regulation, AIFMD, regulators and depositories;
- Sustainability as a governance issue and reporting under GRESB
- The ability to replace the manager;

A couple of cases:

The Morgan Stanley Real Estate Funds China case

The Henderson infrastructure case

The Morgan Stanley Real Estate Funds China case

THE WALL STREET JOURNAL.
EUROPE EDITION Sunday, October 13, 2013 As of 4:18 PM BST

Corruption Currents

Commentary and news about money laundering, bribery, terrorism finance and sanctions.

August 17, 2012, 12:11 PM

Former Morgan Stanley Exec Gets Nine Months in FCPA Case

By CHRISTOPHER M. MATTHEWS CONNECT

A former rising star at Morgan Stanley's Shanghai office was sentenced to nine months in prison Thursday for evading internal controls required by a U.S. foreign bribery law.

Reuters

Garth Peterson, a former managing director in

Don't Miss [?]

The Morgan Stanley Real Estate Funds China case

- A managing director in Morgan Stanley's real estate investment and advisory business in Shanghai entered into a corrupt arrangement with a Chinese official from 2004 to 2007;

- This breached the US Foreign Corrupt Practices Act which outlaws the payment of bribes to overseas officials;

- Individual jailed in the US for nine months and banned for life from the securities industry;

- No action against Morgan Stanley in view of cooperation, but...

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Why is this important?

- Although no action against Morgan Stanley, huge impact on the MSREF funds business;
- US fund managers have significantly strengthened controls to reduce the risk;
- Other countries have introduced similar legislation, eg the UK Anti-Bribery Act.

The Henderson infrastructure case

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News

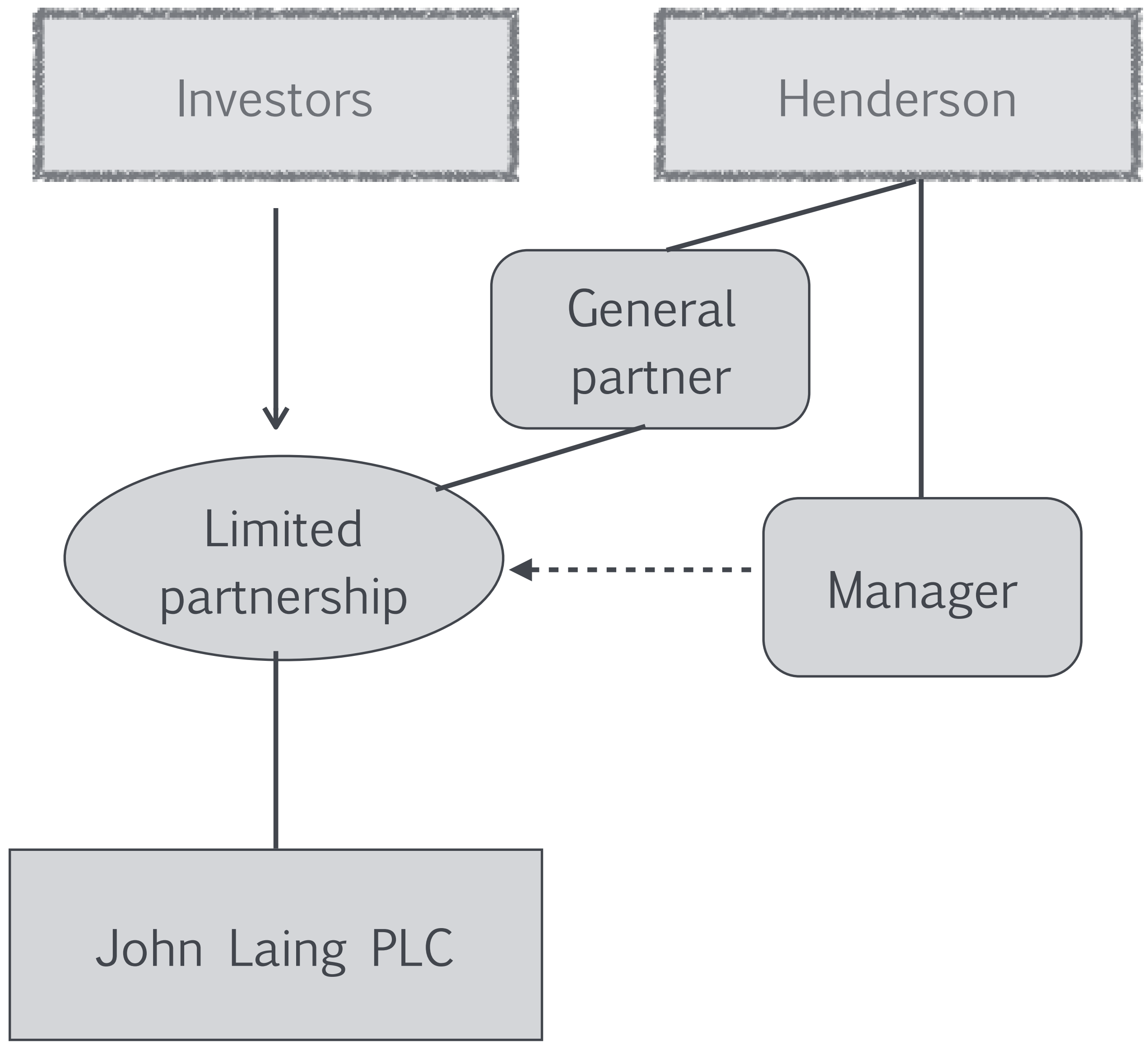
Dozens of pension funds sue Henderson over John Laing deal

07 Dec 2011

UK - Several dozen UK pension funds have filed a lawsuit against Henderson Global Investors over its £1bn (€1.2bn) decision to buy infrastructure group John Laing in 2006.

Claimants are understood to include the £9bn BBC Pension Scheme and Railpen Investments, which administers £18bn in assets for the Railways Pension Scheme, as well as the corporate pension funds for defence company BAE Systems and medical insurer Bupa.

The Henderson infrastructure case



- In 2006. Henderson raised £576m for its PFI Secondary Fund II to invest in PFI projects;
- Fund established as a limited partnership with Henderson entities as general partner and manager;
- In December 2006, £530m of equity raised used to buy a single investment, shares in John Laing PLC, a construction company involved in PFI projects;
- Following the financial crisis, value of the investment fell by two-thirds;
- Investors want Henderson to be sued for acting outside the remit of the fund.

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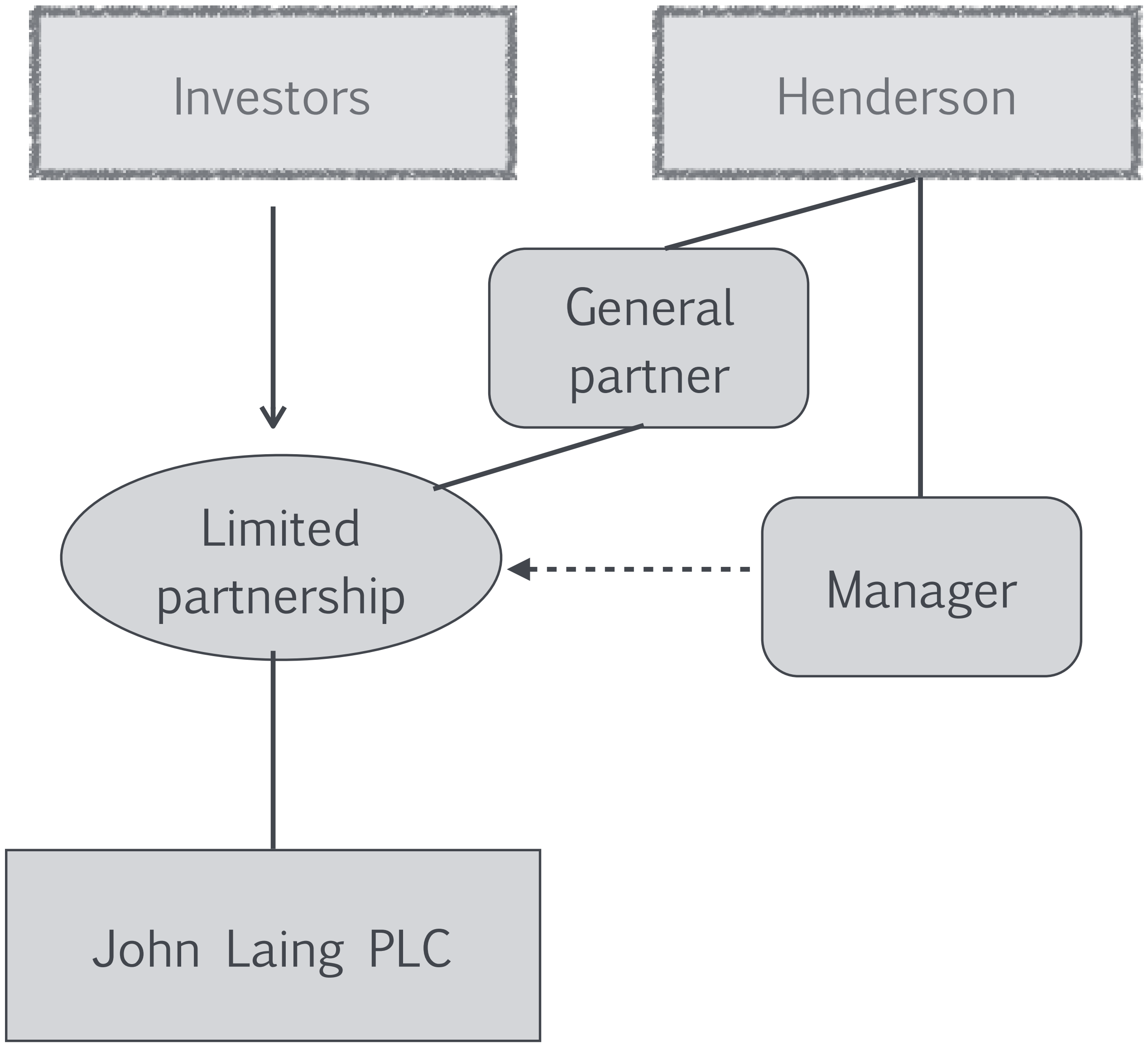
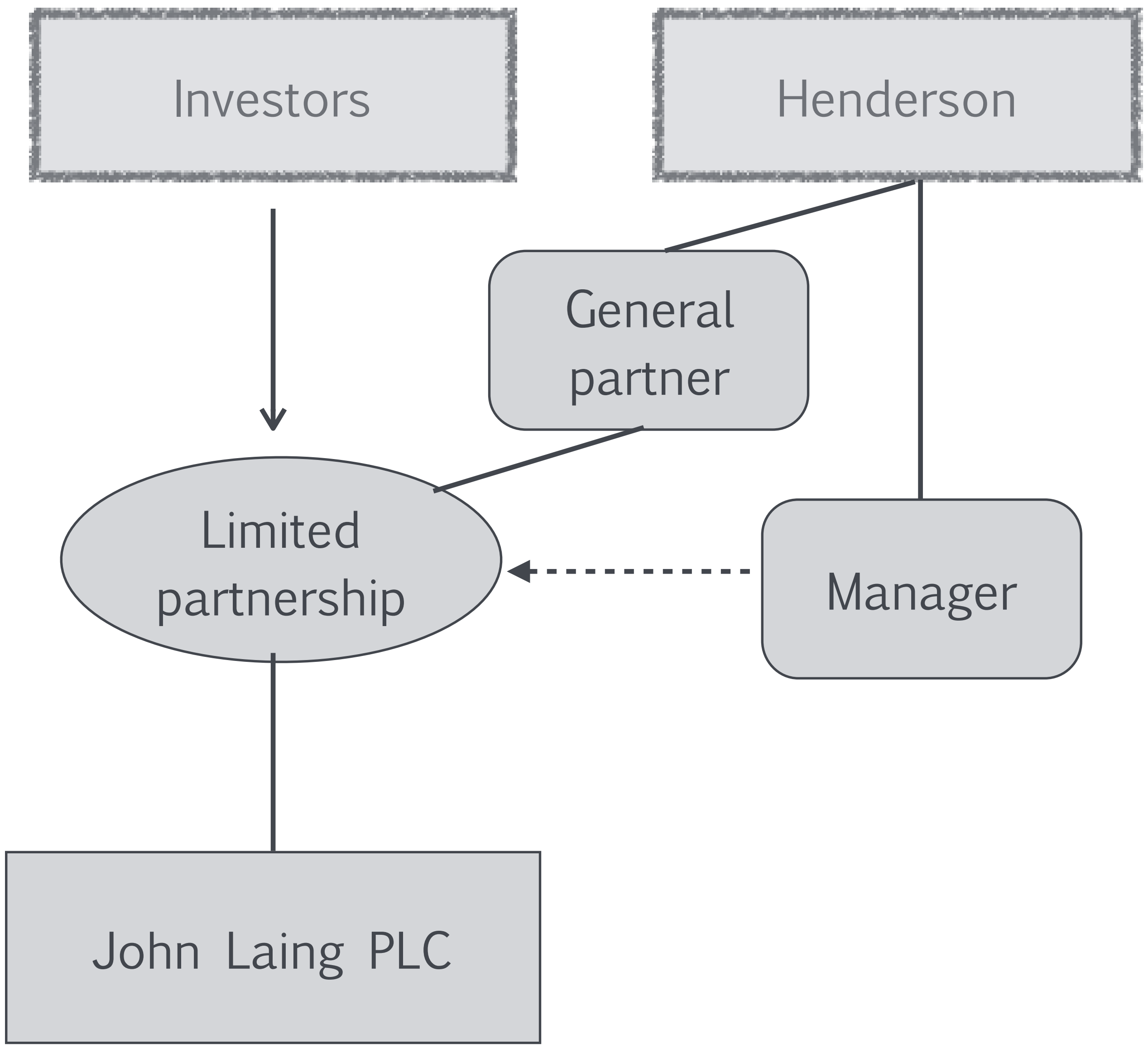
The Henderson infrastructure case



Two interesting questions:

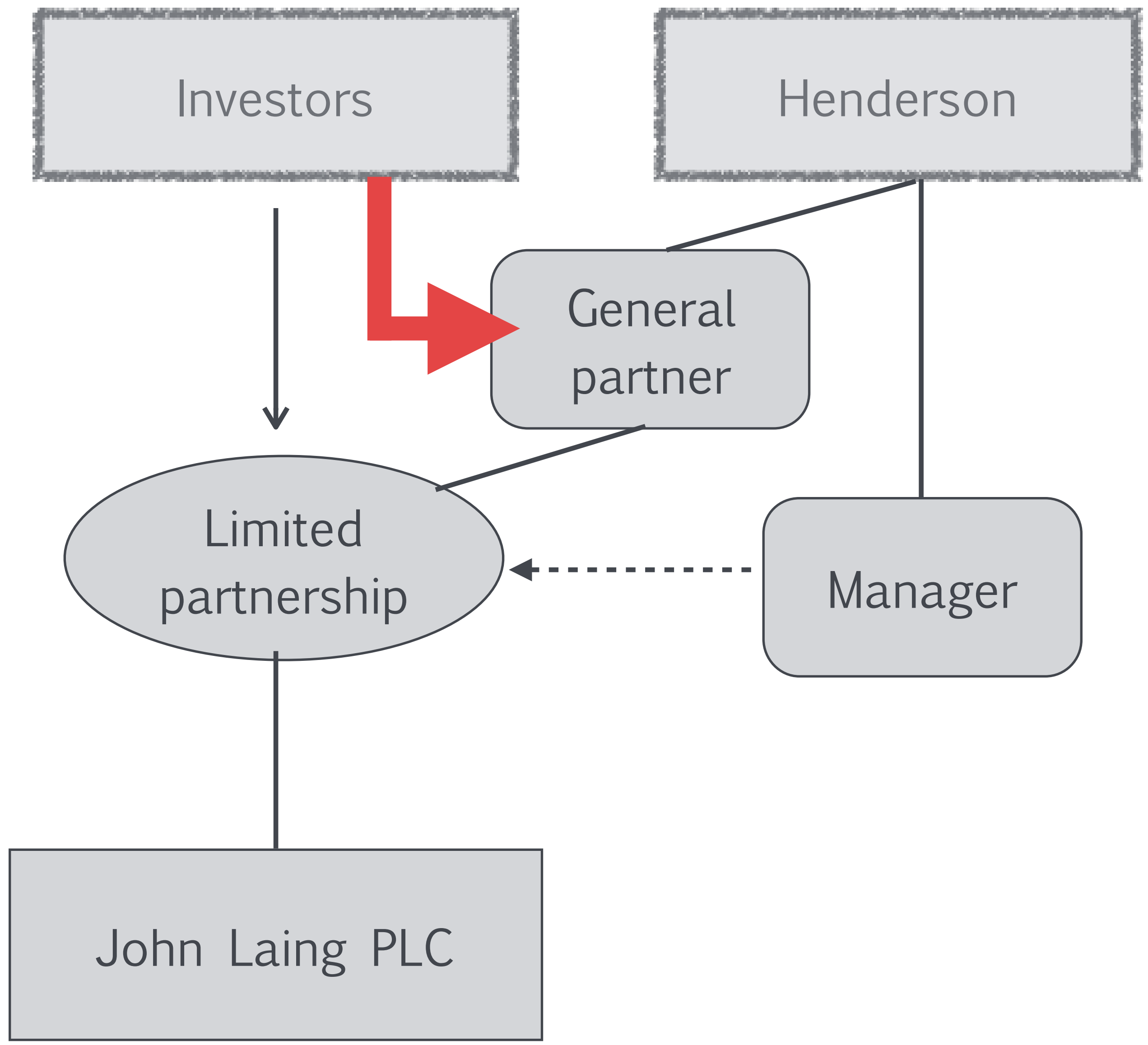
- Can the investors sue the manager?
- Did the manager act outside its remit?

The Henderson infrastructure case



Can the investors sue the manager?

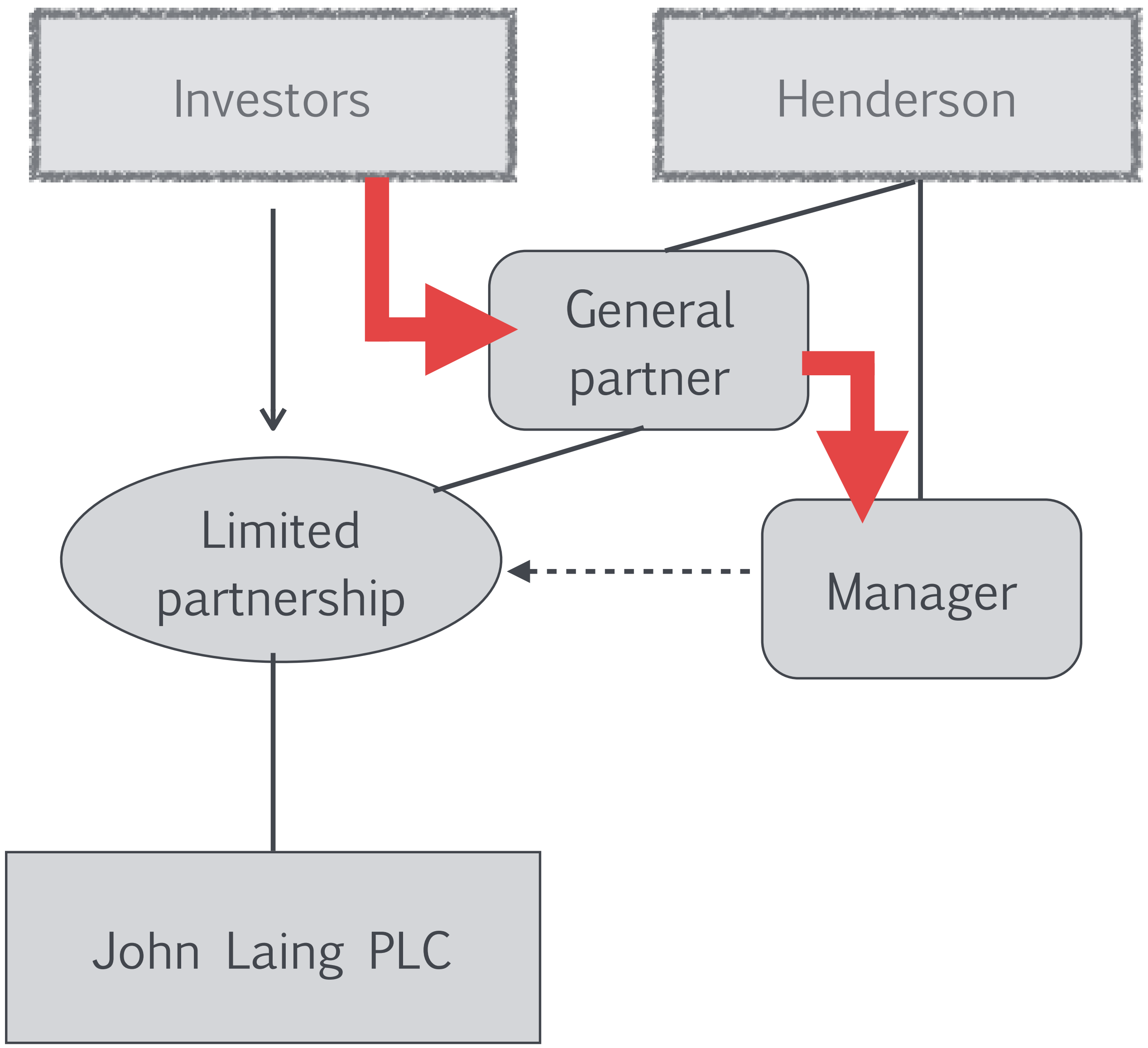
The Henderson infrastructure case



Can the investors sue the manager?

The investors can sue the general partner;

The Henderson infrastructure case

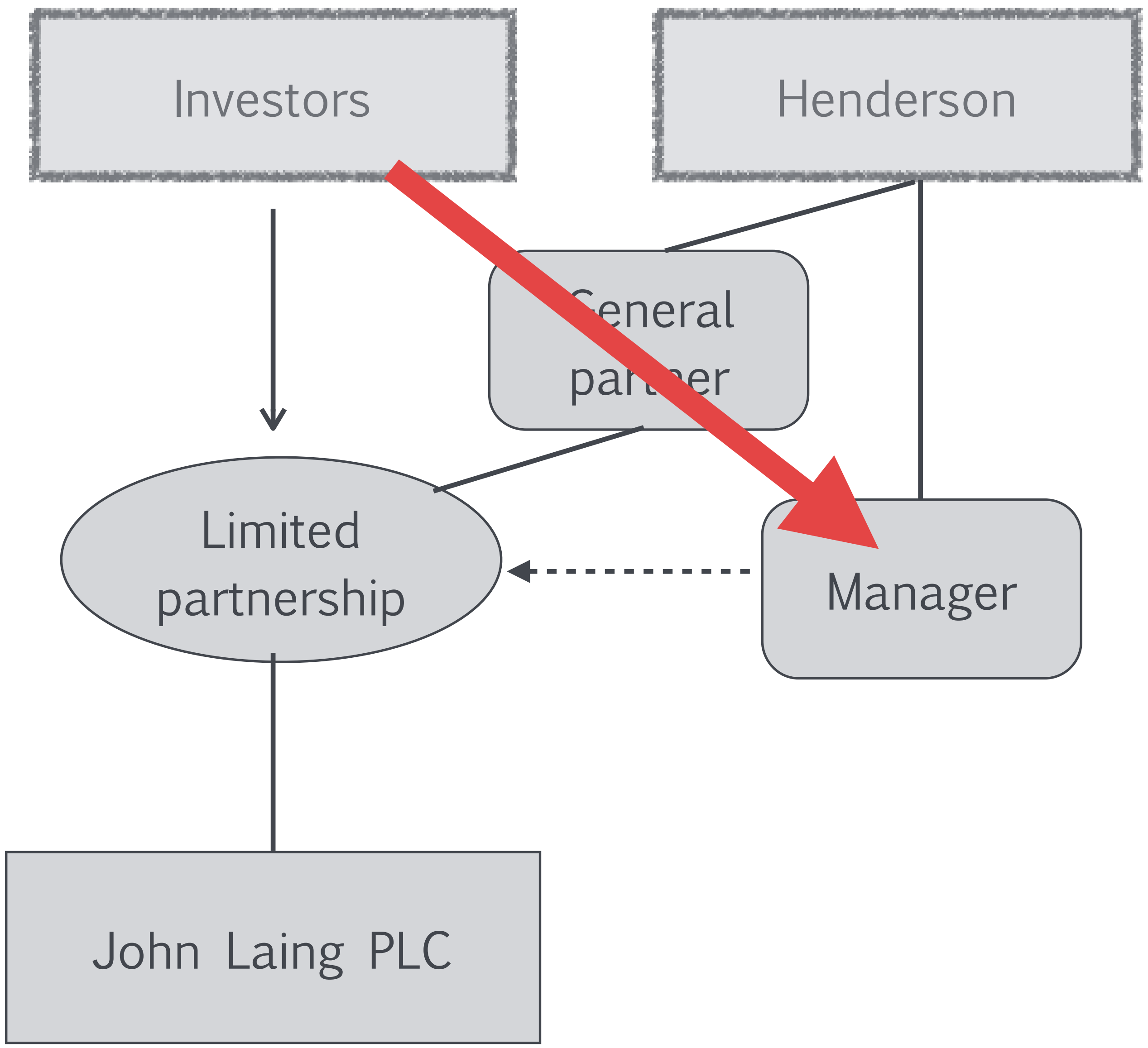


Can the investors sue the manager?

The investors can sue the general partner;

The general partner can sue the manager;

The Henderson infrastructure case



Can the investors sue the manager?

The investors can sue the general partner;

The general partner can sue the manager;

In certain circumstances, including an irreconcilable conflict of interest, the investors can sue the manager directly; but.....

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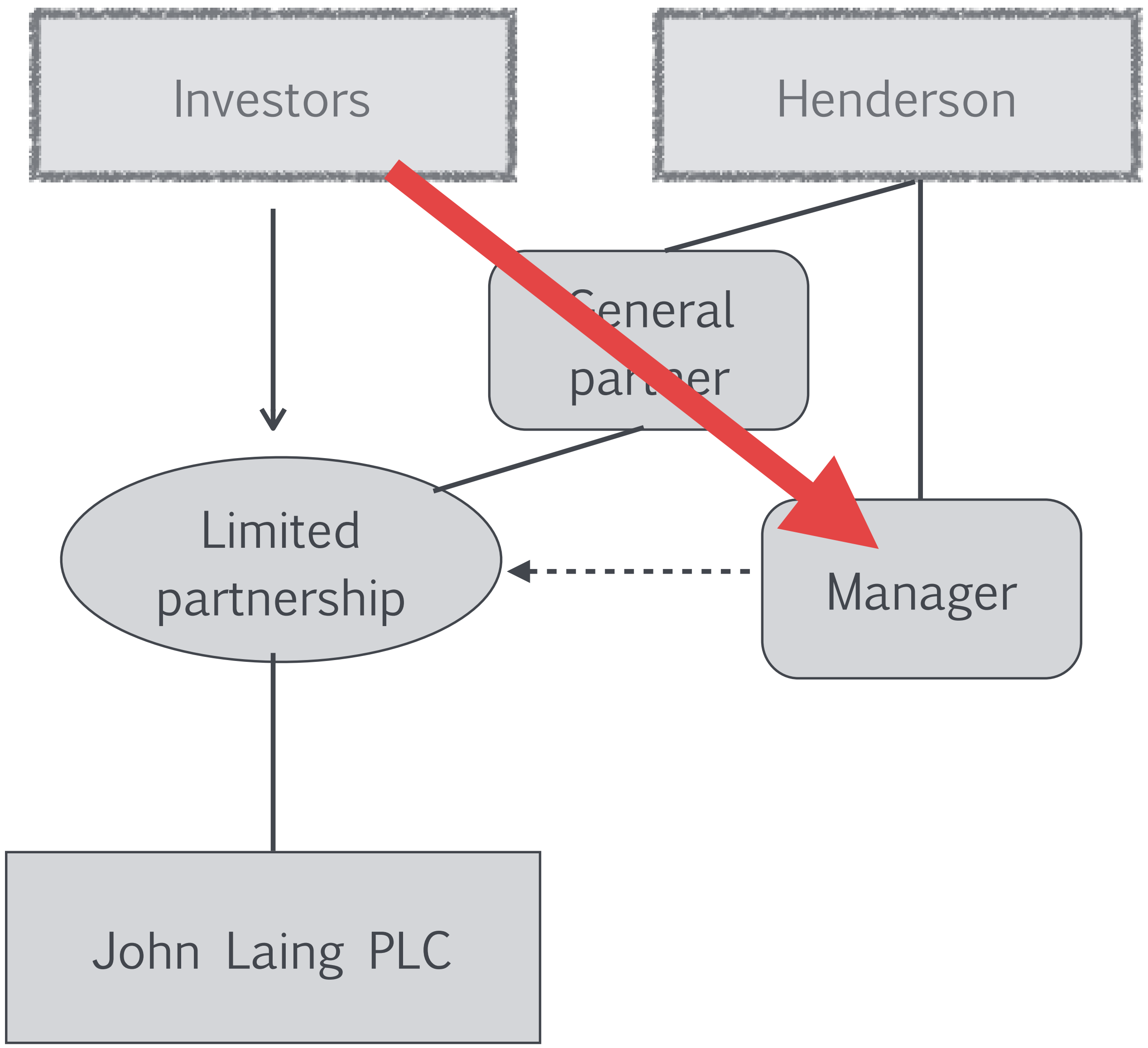
The Henderson infrastructure case



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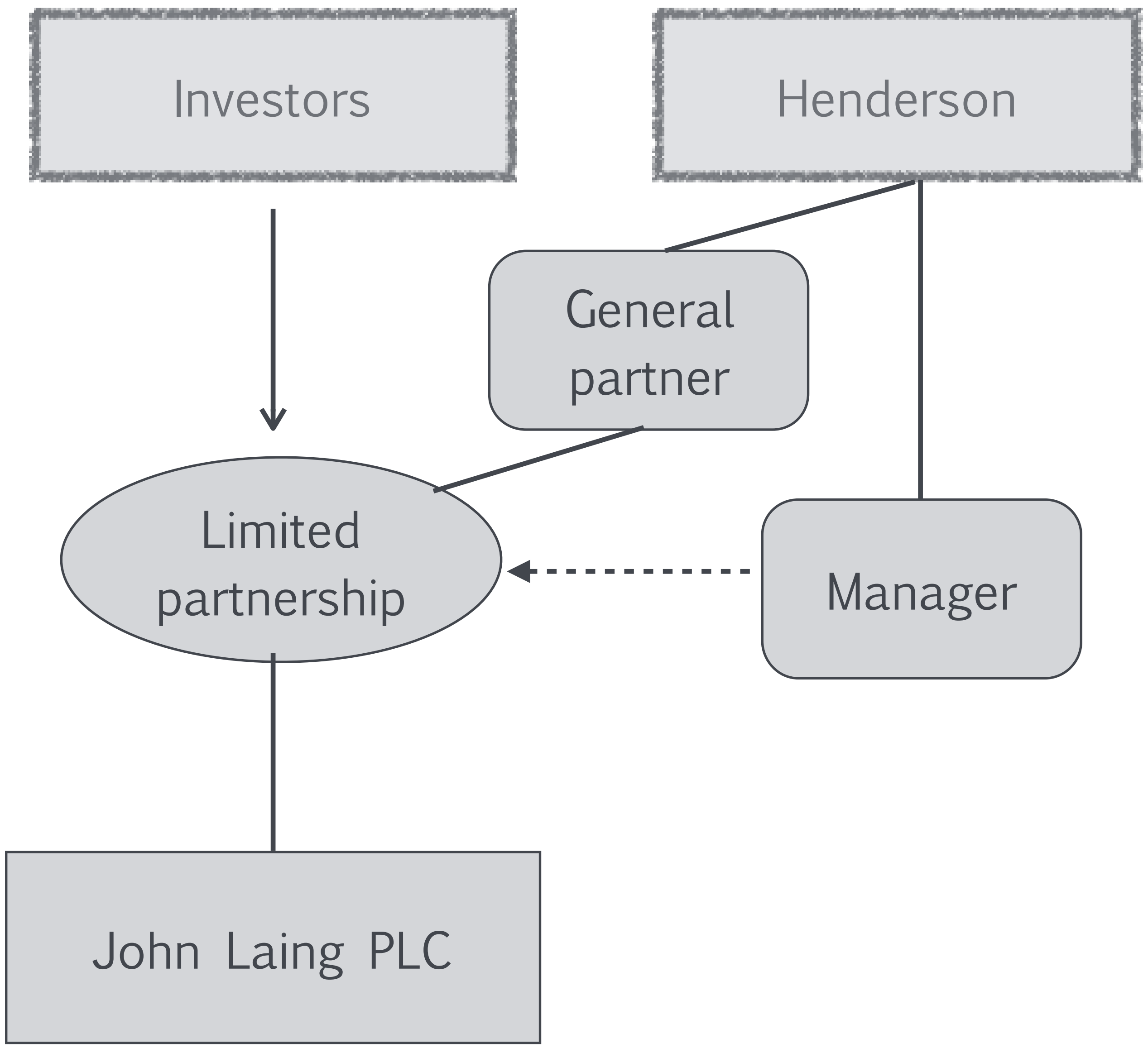
This is regarded as management and they lose their limited liability for the duration of the litigation.

The Henderson infrastructure case



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The Henderson infrastructure case

- Henderson won in preliminary hearing in November 2012;
- The investors had the right to appeal, but settled with Henderson for the payment of their costs.

The Henderson infrastructure case

- Henderson won in preliminary hearing in November 2012;
- The investors had the right to appeal, but settled with Henderson for the payment of their costs.

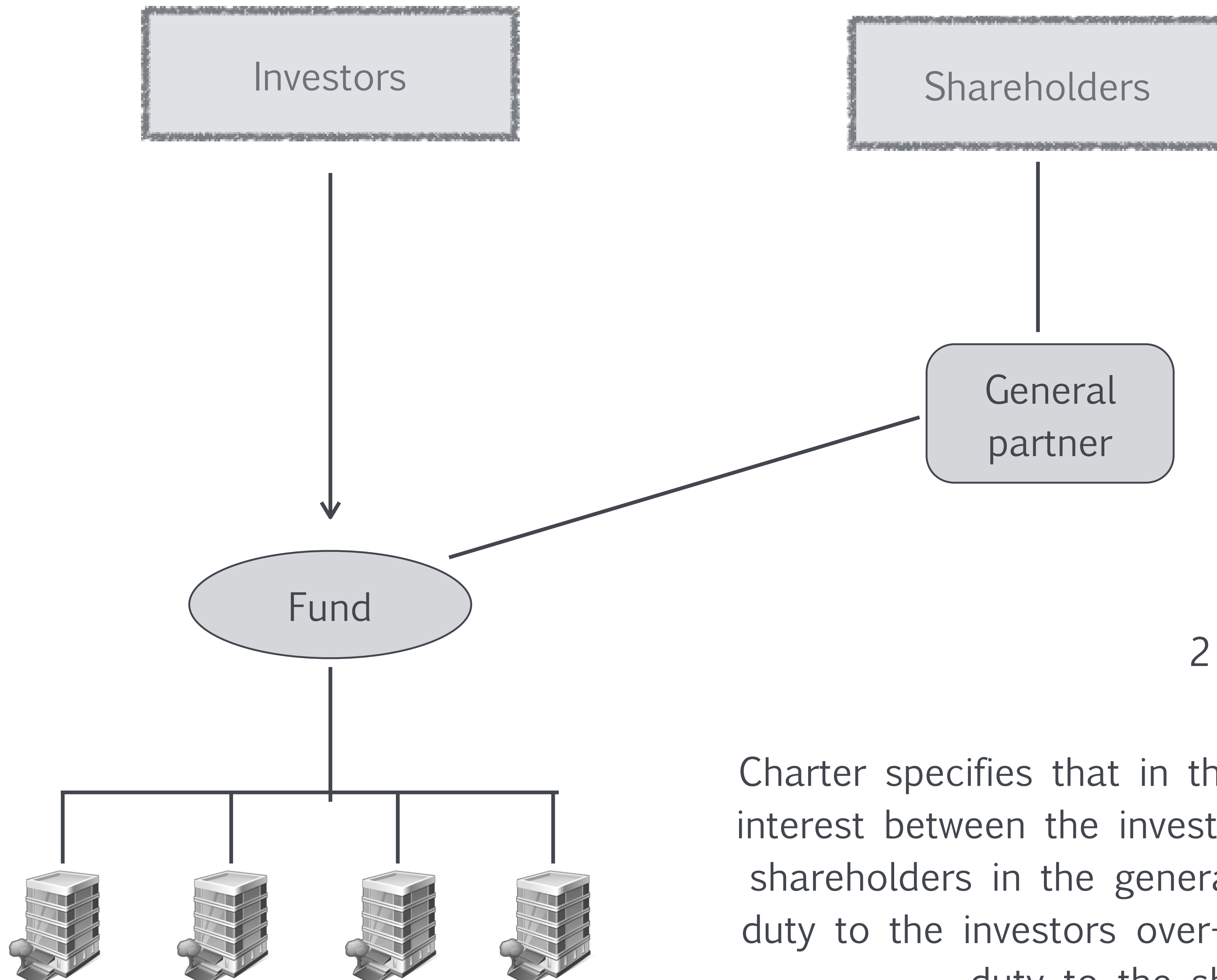
One of the investors, speaking on condition of anonymity, said: "We had to recognise how difficult it was going to be to hold a consortium together to make a further appeal. The case shows the importance of reading the fine print in situations like this and not just relying on marketing material."

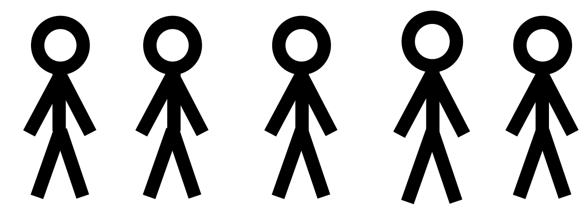
The Henderson infrastructure case

Two challenges:

- situations where the general partner is conflicted - is there a better model?
- achieving consensus amongst investors.

An Australian example



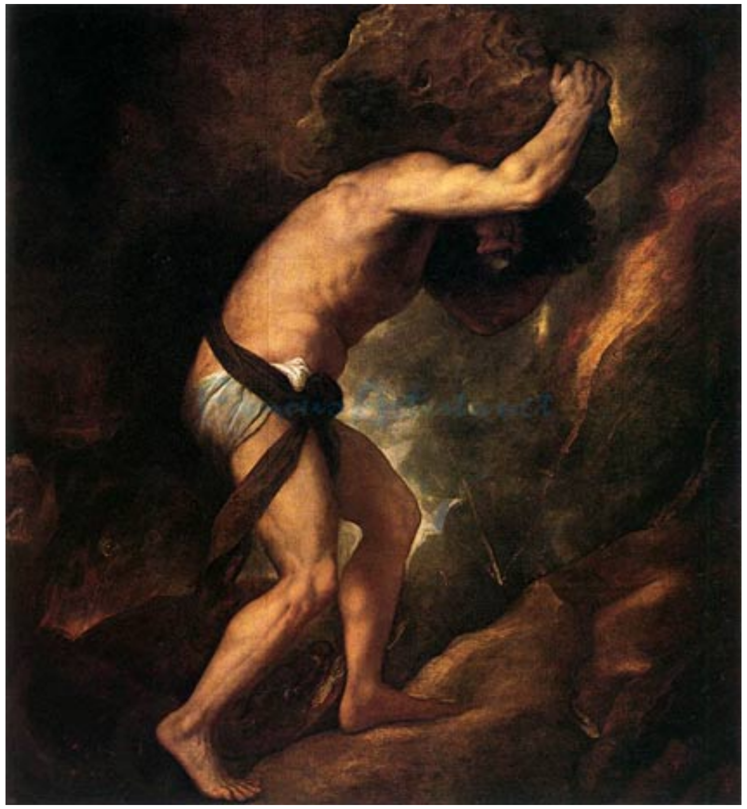


Board of directors
Independent chairman
2 executive directors
2 non-executive directors

Charter specifies that in the event of a conflict of interest between the investors in the fund and the shareholders in the general partner, the fiduciary duty to the investors over-rides the corporate law duty to the shareholders

The rock of Sisyphus

Facing the burden of regulation



Presentation to the Real Estate Investors' Forum
18th September 2013

John Forbes
CONSULTING LLP

The burden of regulation

- AIFMD
- Dodd Frank
- FATCA
- Solvency II and IORP

- Some common themes
- What do I do as an investor?


Sisyphus by Titian

John Forbes
CONSULTING LLP

Some common themes

- Regulatory uncertainty - formal regulation lagging introduction;
- Written policies, procedures and controls;
- Reporting to investors and regulators;
- Due diligence
- Enhanced governance

Impact of regulation on governance

Why is regulation going to create a need for more transparency, stronger governance and greater independent supervision?

- Explicit requirement of regulation;
- A means of satisfying general conduct of business requirements of regulation
- Resolving non-alignment of interest issues arising from requirements of regulation
- Reassuring stakeholders

Who is under the spotlight?

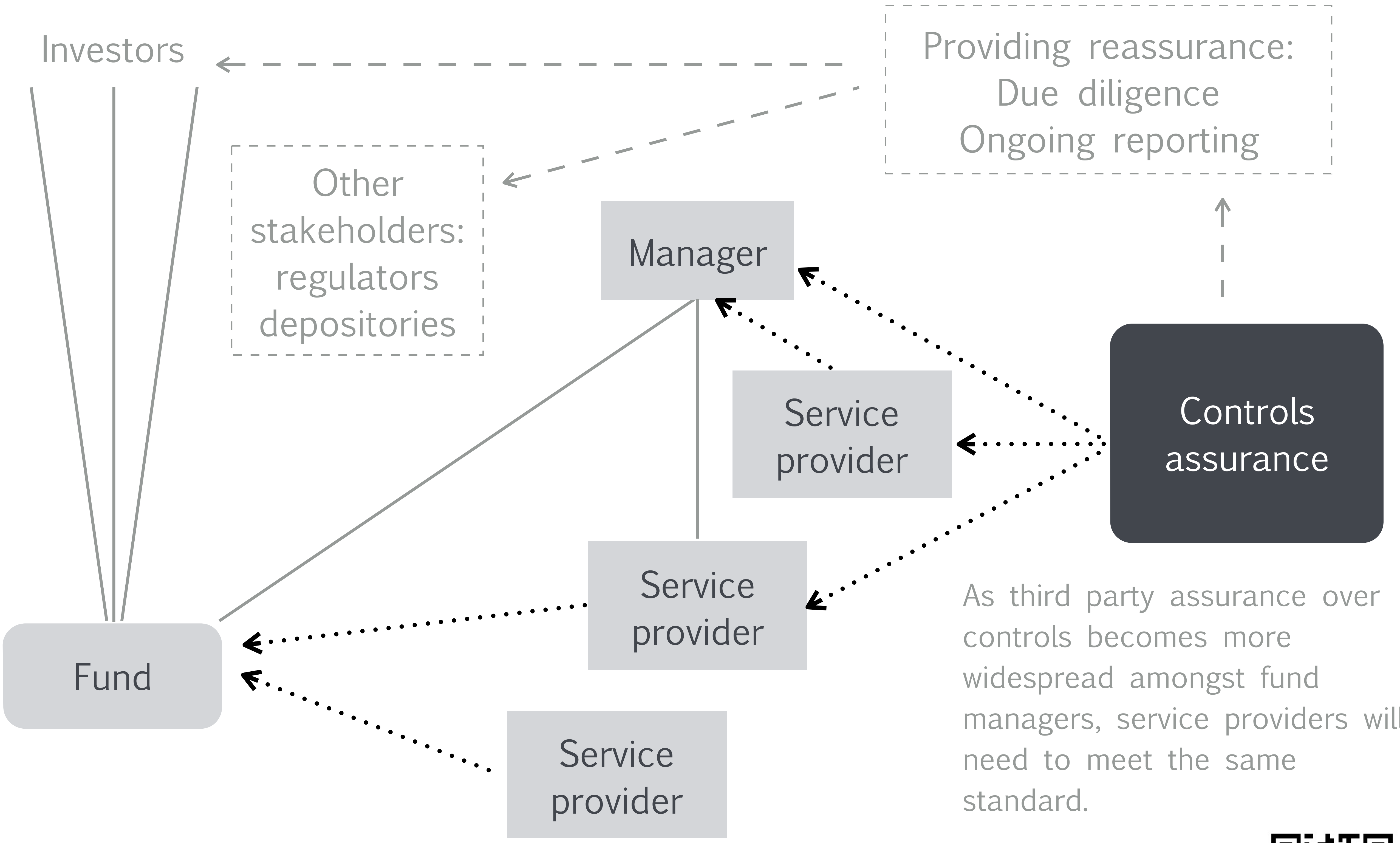
Two service providers in particular:

- auditors
- valuers

The role of the auditor

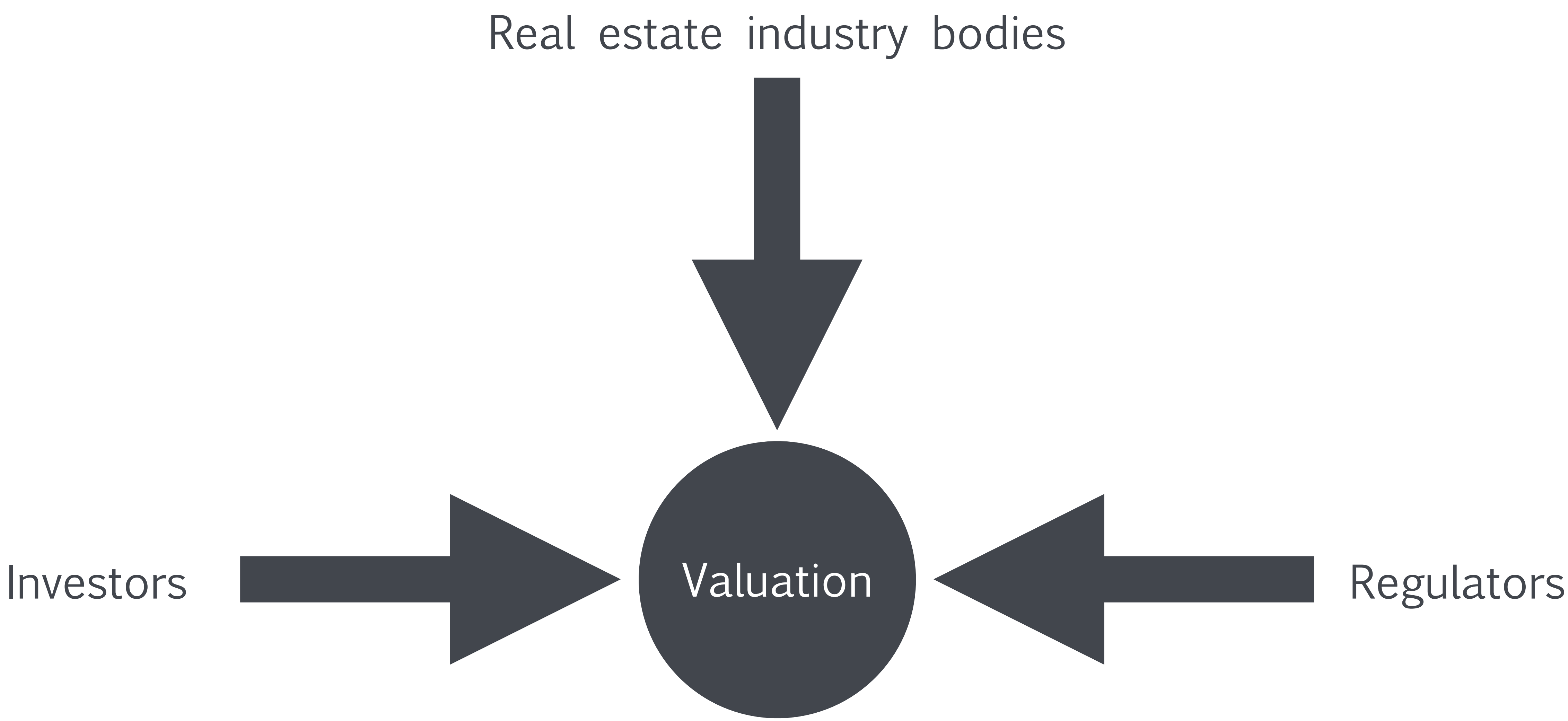
- Audit
- Independent assurance over controls environment.

Independent assurance over controls environment



As third party assurance over controls becomes more widespread amongst fund managers, service providers will need to meet the same standard.

The pressure on valuers



Who is under the spotlight?

Two service providers in particular:

- auditors
- valuers

How is this reflected in governance changes?

What does this all mean?

Notes on the slides

Notes on the slides

Slide 5

Report by PwC for the Association of Real Estate Funds, "Unlisted funds - lessons from the crisis", written by then PwC partner John Forbes http://www.johnforbesconsulting.co.uk/aref-report

Analysis of regulatory environment on http://www.johnforbesconsulting.co.uk/real-estate-investor-forum
Specific commentary on AIFMD on http://www.johnforbesconsulting.co.uk/aifmd

Slides 6 to 13

These slides set out the way in which the provision for retirement feeds through to investment in real estate through direct and indirect channels. In addition sovereign wealth funds are also major investors. The investment of raw material and trade surpluses are increasing this. The drivers for global changes in retirement provision and sovereign wealth fund growth are analysed in more detail on http://www.johnforbesconsulting.co.uk/tipping-point

Slides 14 and 15

These slides provide some bullet points on the key findings of the interviews. A more detailed commentary is provided on pages 47 to 58.

Slides 16 to 31

These slides discuss two cases that are relevant to the analysis here. The MSREF China case was specifically referred to in interviews as an influencer of behaviour.

Slide 32

This slide sets out an example of an Australian governance model, which potentially address the issues raised in the Henderson case. The charter of the general partner company specifies that in the event of a conflict of interest between the investors in the fund and the shareholders in the general partner, the fiduciary duty to the investors over-rides the Australian corporate law duty to the shareholder. Initial investigation suggests that this model would also be possible under UK corporate law if the fiduciary duty to investors obligation was enshrined in the articles of association of the company that acts as the general partner of the fund.

Notes on the slides

Slides 33 to 36

These slides are taken from a presentation to the Real Estate Investor Forum in London on 18th September 2013 entitled, "The rock of Sisyphus"
Facing the burden of regulation. The full slide pack from this presentation is available on http://www.johnforbesconsulting.co.uk/real-estate-investor-forum

Audit of controls environment	1990	1995	2000	2005	2010
SAS 70	US standard for third-party assurance over controls at service organisations 1992 - 2011				
SSAE 16	US				2011 to date
ISAE 3402	International				2011 to date
AAF 01/06				UK equivalent 2006 to date	

Slides 37

Two service providers have come under particular scrutiny, auditors and valuers. The governance implications of this are discussed in the notes to slide 41.

Slide 38 and 39

The independent audit of controls environment for service organisations is getting increasing traction.. A number of leading UK real estate fund managers including Aberdeen Asset Management, Deutsche Asset Management, Standard Life and SWIP have controls audits. Legal and General have announced that they will too.

Type of report	Purpose
Type 1 report	A type I report provides a description of the organisation's control environment at a point in time with a report from the auditor as to the suitability of the controls
Type 2 report	A type II report includes periodic (usually annual) testing of the effectiveness over time of the organisation's controls

The pressure is coming from investors requesting the report as part of their due diligence process, At the moment it does not appear to be a major issue if fund managers do not have the audit performed and the quality of the reports is also rather variable. Over time it can be expected that the coverage and quality will increase.

It is also to be expected that pressure will also come to bear on service providers where a manager outsources some of its activities. This is already starting with fund administrators.

Slide 40

The role of third party valuers is under scrutiny. Investors and real estate trade bodies have been concerned at substantial valuation changes where, for example, there has been a change of fund manager. Under AIFMD the valuer has unlimited liability.

Slide 41

Oversight over auditors and valuers has been suggested by investors as a key role for independent supervisory boards for funds.

The suggestion is that although the manager appoints the auditor and the valuer, the supervisory board would have the authority to question the auditor and valuer on a periodic basis.

Slide 42

Investors and regulators are pushing for better governance and greater transparency by funds. The globalisation of real estate is continuing. The major growth in available capital and investment opportunities over the next decade will be in emerging markets, particularly in Asia. This represents a challenge and also an opportunity for managers in the developed markets. This is particularly the case for London which is a leading, if not the leading, capital market for real estate. If the investment markets and the capital are outside the UK, the London based real estate investment management industry needs to export its expertise. Becoming best in class in governance and transparency, a position held by Australia, as well as innovative product development opens up more than just a domestic opportunity.

People will not invest in funds just because they have good governance, but will avoid those funds that do not.

The interview findings

The interview findings

Introduction

As outlined in the introduction to this paper, the global financial crisis exposed a number of weaknesses in the open and closed-ended fund model as well as short-comings in the industry in respect of governance, transparency, communication with investors, risk management and controls environment. This paper seeks to explore the ways in which international investors, regulators and standard-setters are driving change. A key element of the research has been through interviews conducted with a cross section of investors, consultants, fund managers and placement agents. Details of those interviewed are on page 58.

The key findings of the interviews are:

- Investors are indeed much more focussed on governance, transparency and the operational aspects of the fund managers and joint venture partners with whom they invest. In the aftermath of the crisis, much of investors attention was focussed on either resolving legacy issues or taking positions in existing funds. Much of the new investment was through separate accounts, joint ventures and club deals where the investors have more direct control. It is only over the last year as the raising of blind pool funds has recovered that the changed environment has become more apparent.

- The real estate investment world is becoming more polarised with a small number of very large funds who can continue to name their terms, and everyone else where investors are very much setting the agenda.

- Investors are formalising their processes for due diligence and their ongoing relationships with investment managers and are increasingly seeking to apply standards set by trade bodies such as INREV. Investor concerns are feeding back into the trade bodies which are in turn revising their guidance, with both INREV and AREF updating their guidelines on fund governance.

- Investors are increasingly seeking to apply good examples they see in one area to their investments in another. This is partly through exporting the application of trade body guidelines, but also individual examples of good governance. Australian examples were cited by a number of respondents;

- There is a broad concern amongst investors and managers as to the impact of variations in the sophistication and resourcing at investors with doubts expressed as to the capacity of some investors to meet the additional demands that they are setting themselves.

- Whilst most of those interviewed thought that enhanced standards of governance would remain, some did think that the pendulum might swing back, firstly as pressure to invest overwhelmed the current risk aversion and secondly because many investors and managers do not have the resources to maintain current standards as investment volumes rise.

Polarisation and consolidation

Many of those interviewed identified two broad industry trends that are impacting fund managers in the area of governance and transparency as well as more broadly, but also have an impact on investors and others. These trends are polarisation and consolidation:

- Polarisation - some very large fund managers with a very strong track record are able to raise funds as they have in the past without making significant concessions on either fee arrangements or on transparency and governance. For all other managers, the environment has changed very significantly. They need to meet much higher standards in terms of meeting the increased demands of investors and of regulators. All of this has significant cost implications for managers at a time when there is also considerable downward pressure on fees.

- .

- Consolidation - changes in the industry are creating pressures for consolidation. Regulatory changes and the cost of dealing with stronger governance and greater transparency are contributing to this. Real estate trade press attention has focussed on consolidation among managers, However, some of those interviewed also commented on consolidation amongst investors and amongst consultants, resulting in increased concentration throughout the investment process.

Joint ventures, club deals and local operating partners

There has been considerable comment in the real estate trade press and elsewhere since the financial crisis regarding large investors moving away from investing in funds to instead favouring club deals and joint ventures, with a regular round of speculation as to whether this is accelerating, decelerating or even reversing. It is also worth remembering that many of the funds themselves operate through joint ventures. It has been a long-established practice for the opportunity funds to work with local operating partners. We are now seeing a greater willingness of large investors to conduct their affairs in this way, entering into direct arrangements with local operating partners without the need to go through a fund to get there.

The creation of a joint venture between a global deployer of capital and a local operating partner creates an opportunity for the raising of governance standards as the capital provider can impose its requirements on the local partner.

Some investors adopted the approach of only investing alongside partners who had already built up a track record of being an operating partner for another international investor. This did not, however, guarantee that they met the required standards.

Operational due diligence

As might be expected, since the financial crisis, standards of underwriting and due diligence have become more stringent. In particular, the level of attention paid to operational due diligence has increased significantly in recent years. This covers a number of areas, some more intuitive than others, for example:

- Understandably in light of the events during the financial crisis, there is much more focus on risk management and the controls environment of fund managers;
- In view of the focus on control of investment and divestment decisions, there is much greater attention being given to the process by which such decisions are made;
- There is attention being given to the profitability and viability of managers;
- One feature of the crisis, highlighted in the report for AREF, was that non-alignment of interest between investors was often as intractable as non-alignment of interest between investors and the managers. This is discussed further below, but one of the consequences is that investors are paying greater attention to the mechanisms for resolving such differences.

Methodology

As would be expected, due diligence has, in the view of those interviewed, become significantly more thorough in response to the failings identified in the crisis. In particular, the level of attention paid to operational due diligence has increased significantly in recent years. There remain, however, significant differences in approach:

- Although the use of extensive due diligence checklists has become increasingly the norm, some large investors value a more pragmatic approach. One that is currently in the process of formalising its due diligence process is very keen that this is not at the expense of its current flexible approach that it perceives as pragmatic rather than check box. This approach is highly dependent on sufficient resource being allocated to the task;

- There are also significant differences over the use of standard questionnaires, in particular the INREV due diligence questionnaire. This is gaining increased acceptance and more investors are using it at least as the starting point even if they subsequently ask additional questions. Some of those interviewed who currently do not use the INREV questionnaire have plans to introduce its use. This included investors from outside Europe.

Industry standards

A number of those interviewed cited the standards and guidelines set by INREV and others. As mentioned above, the INREV standard due diligence questionnaire is achieving increasing traction. Based on the interviews conducted for this report, this process is accelerating. It was particularly interesting that investors outside Europe are also setting in place to adopt its use.

Perhaps even more significantly, as the use of these standard due diligence questionnaires becomes more widespread, fund managers are increasingly taking a pro-active approach, preparing a response in advance and sharing this with investors. This is improving the efficiency of due diligence and improving standards, as well as allowing investors to make more direct comparisons. This is a process that can be expected to continue.

Different degrees of sophistication amongst investors

Some of those interviewed felt that the approach to due diligence was dependent upon the sophistication and experience of the investors. More active investors were perceived as having a more refined due diligence process - asking for less but getting straight to the key issues. Less active investors were felt to ask for everything just in case it was useful and to make sure that they did not miss anything. Some respondents expressed the hope that the role of industry trade bodies would help in improving investor sophistication and one investor commented on helping fellow investors in funds in order to improve the quality of investor input on decisions.

Cultural and other local differences

There was also a recognition of the different levels of sophistication of joint venture partners and fund managers, particularly in emerging markets. Approaches to this varied:

- Some investors were prepared to take a more flexible approach in less developed markets, either in absolute terms or in terms of allowing time to achieve thee necessary standards. This is discussed on page 53. Some investors actually felt that it was easier to effect changes to achieve better standards of governance in emerging markets where there is less established precedent.

- Some investors felt that they should maintain the exactly the same standards in emerging markets, although this generally meant not investing in such markets.

- Others achieved a compromise by investing in emerging market only through joint ventures with or funds managed by established players from more developed markets, leaving this partner or manager to deal with the relationships with local operating partners,

Resources

The additional due diligence and supervision requirements being requested by investors create a significant workload for the investors themselves. This is particularly the case where investors sit on advisory committees. There is a question mark over the level of resourcing at some investors. Some of those interviewed acknowledged that they are under-resourced to deal with the increased demands of the approach to investment. Others felt that they were adequately resourced and were taking a very active role in the supervision of managers but commented that they were frustrated by the passivity of a number of their co-investors and felt that this passivity was a reflection of lack of resources at an appropriate level. This was in terms of both the number of people and their seniority.

This reflects comments made at the time of the interviews conducted for the report for the Association of Real Estate Funds, "Unlisted funds, lessons from the crisis". Managers interviewed for that report also complained of passive investors unwilling to take an active role in the decision making process. Three interesting points from this came up in interviews:

- One investor commented that they had taken the initiative to increase interaction with other investors in specific funds and more generally to rouse their peer group from apparent apathy.

- Interviews suggest that investors are employing different approaches to outsourcing to plug shortfalls in their skill set and resources, with the boundaries between traditional consulting arrangements, separate accounts and fund type arrangements for single investors becoming increasingly blurred and for service providers to become more imaginative in the roles that they are prepared to take on. This is also not without its challenges and investors need to think about how they ensure adequate supervision and adequate control, in its broadest sense.

- It was felt that some investors, particularly from the US, were concerned about the regulatory and litigation risk.

One investor also expressed concern that the lack of resources at investors might result in standards slipping again as activity in the market increases. The demands that investors have imposed upon themselves increase the workload but the size of teams has not increased. This is increasingly important as investors in funds push for greater influence through investor advisory committees and also with the vogue for joint ventures and cub deals discussed on page 49 which also require greater input from the investors.

Immediate requirements and longer term plans

A number of those interviewed recognised that the greater demands of investors were conditions that could not always be met immediately by joint venture partners and fund managers. In many cases investors were prepared to distinguish between immediate requirements in terms of governance and transparency and those things that would take local partners longer to achieve, for example reporting under IFRS.

Another example was reporting INREV NAV, which one investor described as an absolute but not an immediate requirement. For all new fund investments, they require the manager to commit to a timetable to achieve INREV NAV reporting. This is not just for European managers and in their view US managers with significant European investors in their funds are also accepting this.

For those with a longer implementation time, many investors were prepared to agree a timetable with the manager / joint venture partner, with some investors prepared to take a very active role in helping them to achieve the objective. The investors concerned took the view that it was not sensible to restrict the investment opportunities by not being prepared to invest time and effort into the operating partner as well as the asset. For obvious reasons, this attitude tended to be more prevalent among investors with a longer term investment horizon

One investor elaborated on this approach by saying that although they need to trust the partner, they do not need to like the partner. They will sometimes go with an imperfect partner if they like the asset. The first step is to assess the asset. If they like the asset, they then consider the partner and in particular if it is too much of a stretch to educate the partner.

Corruption

The regulatory impetus for dealing with corruption is dealt with on page 55. However, investors are concerned with this as an issue beyond meeting the minimum requirements of regulatory compliance. A number of those raised this as an issue, particularly in respect of emerging markets.

Comments from those interviewed included:

- In assessing the risks cited a variety of approaches, The Jones Lang LaSalle Transparency Index is widely used;
- Some investors preferred to invest through Western partners with whom they were already familiar, relying on them to deal with local partners;
- One investor commented that they no longer undertake development in emerging markets as they see this as too high risk. Corruption is most prevalent in the entitlement and planning consent process.

Sustainability

A number of those interviewed regard sustainability compliance as a governance issue and require funds in which they invest to participate in the Global Real Estate Sustainability Benchmark (GRESB) or, in some cases, a comparable equivalent.

More generally this is an area that investors are probing during due diligence and expect managers to have a well-articulated strategy. Many managers do not.

This was an area, amongst others, where Australian managers were felt by many of those interviewed, to be ahead of the rest of the world. As investors focus more on this and increasingly report performance against metrics, those fund managers who do not have the ability to provide the necessary data will find themselves disadvantaged.

Questions are also being raised about self-certification of performance by fund managers and this is therefore an area where, with a growing focus on measurable performance, there will be a corresponding need for a better audit trail and external certification.

Investor advisory groups and independent boards

Whether in funds or in joint ventures, there is a greater demand for supervision of the ongoing operations. In the case of joint ventures, investors increasingly expect to play an active rather than a passive role. In the case of funds, it is now normal to expect there to be an oversight body looking over the activity of the manager. Generally investors are in favour of Investor Advisory Committees consisting of the largest investors.

However, it is recognised that there are a number of practical drawbacks to this:

· Many investors are resource constrained and do not have the time to devote to the role;

· The powers of such bodies are restricted by legal requirements, for example the loss of limited liability for limited partners in a UK limited partnership;

· Concerns over legal and regulatory liabilities. This was felt to be a particular concern of some US investors;

· Smaller investors feel disenfranchised by the increasing powers given to large investors.

Despite the potential disadvantages of the Investor Advisory Committee, this remains generally the preferred oversight body. However:

· Some investors felt that such bodies should have an independent chairman. Investors have seen this on Australian funds;

· Although it currently remains a minority of those interviewed, some investors are in favour of the introduction of independent supervisory boards.

It should be noted that those interviewed are not a representative sample of all investors - the focus of this paper is on large international investors who wold assume that they would be represented on any investor advisory committee. Those who did not feel that they would be, were more inclined to favour independent supervisory boards.

The impact of regulation

In terms of existing regulation, US interviewees cited the impact of the US Foreign Corrupt Practices Act. which outlaws the payment of bribes to overseas officials. This has become a particular concern following the corruption case in China involving the Morgan Stanley Real Estate Funds business, details of which are set out in the slides.

Opportunity funds working with local operating partners concerned to ensure that those partners are not involved in corrupt activities have introduced very robust controls over payments to provide reassurance that illegal payments are not being made. The imposition of such a strong controls environment has had an impact beyond the immediate desire to prevent corrupt payments.

The UK has now also introduced anti-bribery legislation. It will be interesting to see if efforts to comply bring fringe benefits in terms of stronger controls more generally

.

Dealing with corruption is also discussed on page 53

The introduction of the Alternative Fund Managers Directive (AIFMD) imposes detailed requirements in respect of operational matters for fund managers. As discussed further below, this should in many cases result in enhanced governance and control.

In the longer term the introduction of Solvency II for insurance companies and the Institutions for Occupational Retirement Provisions (IORP) Directive for pension schemes will have an impact. Life Insurance Companies and Defined Benefit Pension schemes are major investors in real estate as an asset class. Both Directives include transparency and governance requirements that will have a knock on effect on managers through whom they invest in funds and separate accounts. More information on Solvency II and IORP is available on http://www.johnforbesconsulting.co.uk/solvencyii

As outlined in the slides, increased regulation of the real estate investment management industry is likely to create a need for more transparency, stronger governance and greater independent supervision for several reasons:

- It may be an explicit requirement of the regulation
- As means of satisfying the general conduct of business requirements of the regulation, for example in AIFMD.
- Resolving non-alignment of interest issues arising from requirements of the regulation
- Reassuring stakeholders of compliance with regulation. Many of those interviewed expressed concern that the industry is not yet prepared for this.

The impact of listing

As indicated in the slides, stock exchange listing requirements impose governance and transparency standards;. Furthermore, companies from one territory listing in another result in an export of standards, for example overseas companies with London main market listing. There are two significant areas where this has an impact on the real estate investment management industry:

- Investors have the ability to invest in real estate through listed investment vehicles. In recent years listed funds have been joined in the investment spectrum by an increasing range of REITs in many jurisdictions. Unlisted funds need to raise their governance and transparency standards to match that of REITs;

- The listing of fund managers, particularly the listing in recent years of large US private equity houses, is enhancing governance and transparency at the manager level. This does not mean that anything has changed at the fund level, and indeed investors believe that the successful US private equity fund managers who have listed are least likely to have changed their terms at the fund level. Equally those managers have also been the most successful at raising new equity so feel little pressure to change the model.

The role of the auditor and independent audit of controls environment

More real estate investment managers and service providers to those managers are having their controls environment audited by the a third party. More investors are requesting this, particularly under the international standard ISAE 3402. Although a number of those interviewed for this report said the requested it and regarded it as highly desirable, none said that it was an absolute requirement that would prevent them investing with a manager.

What if it all goes wrong?

A contentious area is the ability of the investors to remove the manager.

This is something that is likely to become increasingly important with the advent of funds with loner or perpetual lives and limited liquidity. The terminology currently used by INREV and others is for "change of manager without cause". Based upon the interviews conducted for this paper this is an important concern for investors, but the current terminology would appear to be misleading and not reflective of what investors want. Investors want the ability to remove the manager for a failure that has not been pre-determined in the fund documentation. Greater clarity and less provocative terminology in this area would appear to be helpful.

Does good governance and transparency make a difference?

People will not invest in funds just because they have good governance, but will avoid those funds that do not. Many of those interviewed said that there were instances where they chose not to invest because managers or joint venture partners did not reach the requisite standards of governance and transparency. Where investors were prepared to give time to comply, there were also instances where they walked away from potential investments as they felt that additional time would not solve the problem. There is a clear message to managers that this is an area where effort is needed and will be recognised by investors.

Those interviewed

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