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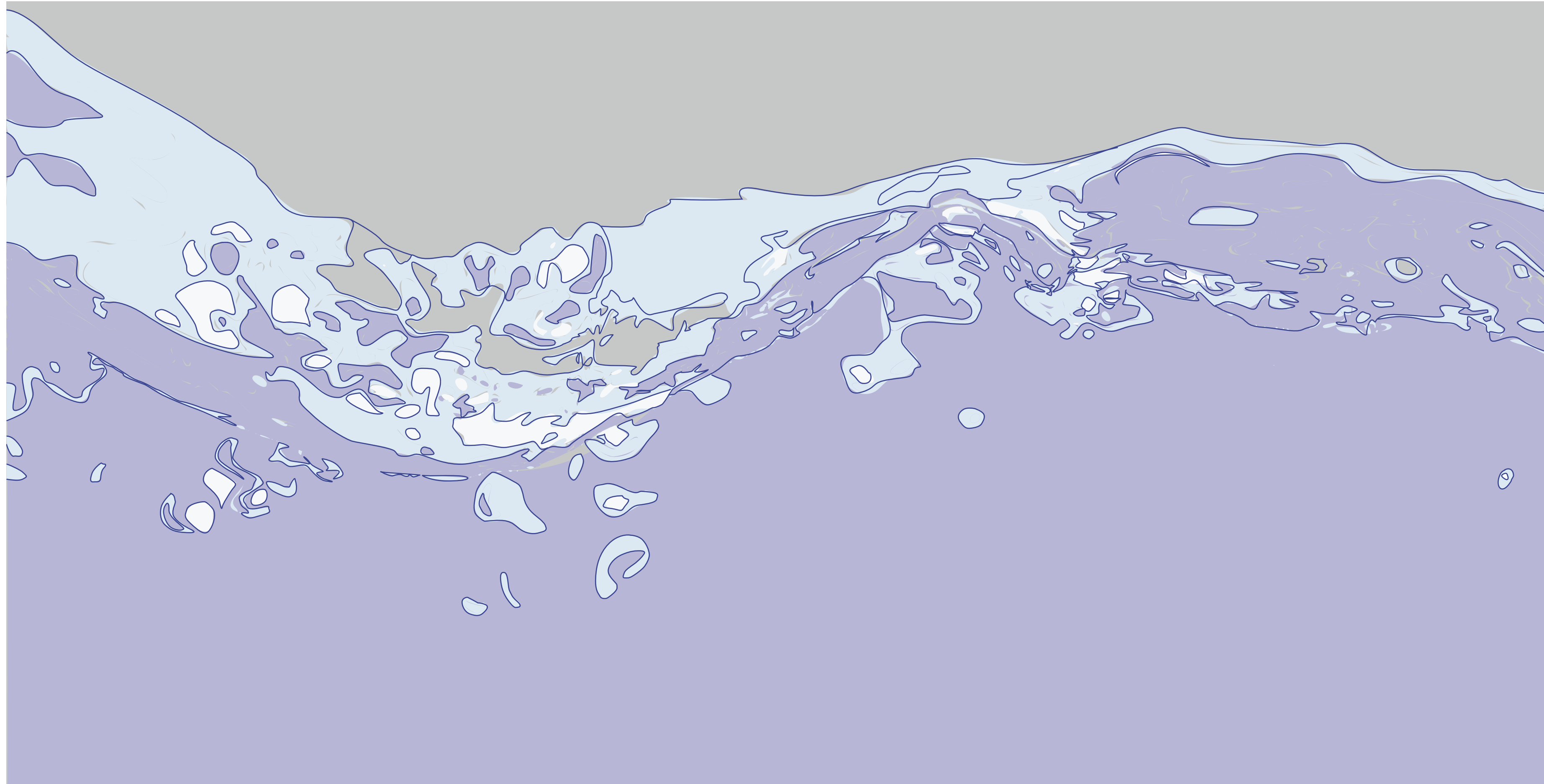

# Pillars to Ensure Open End Fund Liquidity
# **Updated December 2018**

Professional Standards

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As a pan European body, INREV represents an excellent platform for the sharing and dissemination of knowledge on the non-listed real estate industry.

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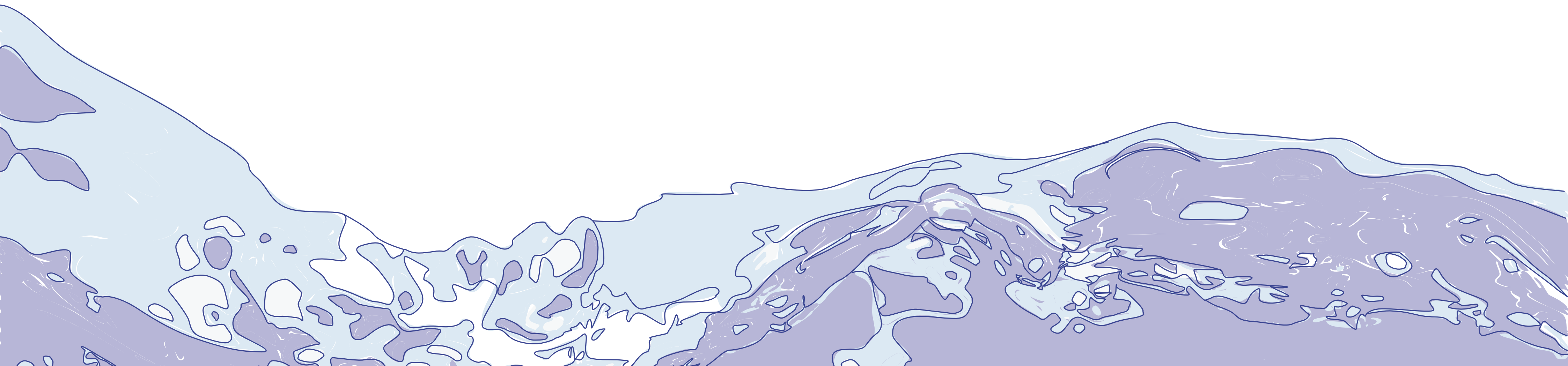

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# Pillars to Ensure Open End Fund Liquidity

**Establishing a fair practice framework for investor exits**
According to INREV's study on the Investor Perspective on Indirect Real Estate Liquidity (2015), investors acknowledge that indirect real estate is a relatively illiquid asset class compared to equities and bonds. This is a function of both the illiquidity of the underlying assets, which itself varies by sector and location, and the additional complexity of trading heterogeneous indirect holdings in a market with a transaction volume smaller than that of the direct real estate market.

This paper concentrates on the creation of liquidity in open end fund structures, which differ in two main aspects from their closed end counterparts.

- Open end funds by definition do not have a set expiry date,
- Open end funds allow their investors to withdraw by redeeming their investments, while closed end funds lock in the invested capital until the defined maturity date.

Open end funds therefore appear to offer investors more liquidity than closed end investments. However, during the financial crisis many open end fund managers were not able to meet increasing redemption requests and investors were not able to liquidate their assets in advance of anticipated declines in NAV. Depending on the agreed fund terms, managers either suspended redemptions or were forced to sell assets to meet capital demands. In the latter case, many sales were made at prices below book value.

In this context, a clear framework setting out investor rights together with manager responsibilities and scope for action, would help to create realistic expectations for open end fund investments and to avoid conflict between the parties involved. The liquidity module of the INREV Guidelines aims to help investors understand their liquidity rights and risks at any time during the investment period. The transparent statement of rights and obligations, which should lead to fairer trading and the equal treatment of all parties, is a core principle of the INREV Guidelines.

For the purpose of improving indirect real estate market liquidity, the investors questioned for the 2015 INREV study mentioned increased transparency, document standardisation and increased indirect real estate market size, as the three most important factors. As a consequence, this paper focuses on particular disclosure requirements that will lead to more transparency in assessing liquidity levels and investigates how far differing market sizes in Europe either foster, or limit access to secondary markets.

> 'The aim is to describe a best case scenario where investors and fund managers can go on to further successful investments in follow-on or new funds.'

Comparing behaviours in a number of different European countries, the INREV Secondary Market and Liquidity Committee has identified five pillars upon which a liquid open end fund should be built. Thereby this paper should help all parties to implement a fair and effective redemption and unit cancellation framework for open end funds and also to develop local best practices, given that the INREV Guidelines' scope is limited to a broad European point of view. The aim is to provide practical guidance in explaining the conditions for exiting out of open end funds, to avert conflicts between involved parties. The key aspects of the recommended framework are summarised in a checklist enabling fund managers and investors assessing their positioning.

This study has been updated in 2018 to include a new section on the valuation of units for the purposes of secondary trading. The local best practices section has been also extended to include highlights from the United States.

Updates to the study are minor and aim to further protect the liquidity rights and interests of investors.

# Section 1

## Clarifying the terms and rights of redemption

# Clarifying the terms and rights of redemption

**‘Half of all investors would like the ability to trade in or out of an indirect position within 12 months of deciding to do so.’[1]**

Central to any investment in an open end fund is an investor’s right to the return of capital, by way of redemption of their holding. The process for redemption is usually described in the fund documentation, such as the fund’s memorandum and articles of association. However, these documents need to be read in conjunction with a number of statutory and common law principles that are particular to the individual fund and its jurisdiction. Investors have to be aware of this interplay and understand their rights at any stage of their investment. Otherwise, circumstances where the redemption process is interrupted can frustrate ill-informed investors.

In general, redemptions work well during normal market conditions; however in a period of economic, political or environmental turmoil the role of the manager includes balancing the interests of those investors who wish to leave the fund and those wishing to remain. It therefore needs to be ensured that there is a provision in the fund documentation for redemptions to be suspended.

The INREV Guidelines’ Liquidity Module requires that ‘Overseeing the establishment of a fair liquidity mechanism and the disclosure of it to investors should be one of the objectives of a vehicle’s corporate governance activities’.

Most conflicts between investors and fund managers in open end funds tend to arise with investor exits and complete fund terminations. To prevent misunderstandings and ignorance among investors, fund documents should be written in clear language, unambiguously explaining the redemption terms and outlining those circumstances in which the normal redemption terms do not apply.

## Defining redemption window, hurdle rate and sell prioritisation

INREV’s research study into Investor Perspectives on Indirect Real Estate Liquidity (2015) showed widespread agreement amongst investors that some open end funds are unable to provide their intended liquidity in all market conditions, particularly during periods of market distress. For this reason definitions of redemption windows, periods in which redemption requests need to be served and other aspects of the withdrawal process are often undermined by exceptional circumstances which allow the fund manager to deviate from the normal rules.

‘Open end funds are vulnerable to herd instinct so can’t work in all environments’.[1]

**Exceptional circumstances**

It is recommended that an open end fund should reserve the right to extend its redemption window by up to two years in total (including extension), but only under exceptional circumstances. An additional tool that the manager has at its disposal is to adjust the usual redemption price; but again under only exceptional circumstances.

The definition of ‘exceptional circumstances’ may be subjective, but the intention is that this should be properly applied by fund managers, akin to a force majeure clause, only coming into effect when circumstances are clearly outside those of a normally functioning real estate market. The fund manager should not invoke ‘exceptional circumstances’ when it is unwilling to sell assets just because this would reduce their assets under management (AUM), an approach which has been taken in the past. Investors understand that there will be fluctuations in asset prices over the investment cycle, meaning that at times assets may need to be sold either above or below their prevailing valuation in order to service redemptions.

An exceptional circumstance may be economic, political, (eg the UK’s referendum vote on remaining in the EU) criminal (eg terrorism) or any other event that has a major direct or indirect impact on real estate values in the short medium or long term. An exceptional circumstance is a single event or a chain of events that may trigger the listed real estate market to decrease by a material amount (say 5% in a day or 10% in a week).

1 Investor Perspectives on Indirect Real Estate Liquidity 2015, INREV

Types and examples include (but not on an exhaustive basis) some or all of the following:

- Political eg the UK's referendum vote on whether to remaining in the EU;
- Criminal eg terrorism; and/or
- Economic eg severe movements of currencies of stock indices or any other event that has a major direct or indirect impact on real estate values in the short medium or long term.

Where the impact of an exceptional circumstance on a fund's underlying property valuations has yet to be seen clearly, then it may be considered reasonable for the fund manager to adjust the liquidity provisions temporarily. This may mean adjusting the exit price or pausing / delaying any redemptions. This should only occur if the fund's independent valuer has caveated their valuation on the fund, along the lines that the reliance that can be placed on the valuation has been reduced, due to these exceptional circumstances.

'Deviation from normal redemption terms should only be allowed under exceptional market situations and the condition that these are comprehensively explained to the investors.'

In any event, the tools at the disposal of the fund manager should be clearly documented and accessible to investors at all times.

In this context the nature of exceptional circumstances should be clearly defined in the fund documentation, and the fund manager should be obliged to explain these to the investors, if the redemption window is extended on these grounds. In general, exceptional circumstances imply extraordinary market fluctuations or a state of the market that does not resemble the conditions under which the redemption terms were determined. Normal market volatility and deviations should not be a sufficient rational for claiming exceptional circumstances, as the fund manager should be aware of these.

Deviation from normal redemption terms should only be allowed under exceptional market situations and under the condition that these are comprehensively explained to the investors.

**Price threshold**
Opinions on when extraordinary market conditions occur which form the basis for extending the redemption window are likely to vary between fund managers and investors, due to their differing positions. Investors wishing to liquidate their holdings may well be in disagreement with a fund manager at certain points in the cycle, for example if the latter is unwilling to sell assets to meet redemptions. In order to avoid such conflict, it should be considered that the fund terms may define a minimum percentage of value or a minimum monetary amount at which managers will be committed to sell off assets to meet redemption requests. Such a threshold could be defined as a certain percentage of the fund's net asset value as at the current market valuation (X% of NAV).

The fund documents should clearly and unambiguously define the redemption terms and not be discretionary. In order to achieve this, it is highly recommended to provide an example of how the redemption terms work.

The fund documents should also define appropriate measures in case the fund manager is unable to meet redemptions requests by selling assets in the agreed redemption window.

**Consequences of breach**
For cases where fund managers abuse their position with regard to redemptions, there should be conditions built in to protect the redeeming investor. Such provisions could for example allow for fee deductions on the basis of the redeemed amount. The documents should be precise on when a fee reduction can be enforced; this might be at the time when the redemption period is extended or when the maximum redemption period (for instance two years) has been reached.

**Prioritisation of selling assets**
When setting up the framework for liquidation, it may also be pertinent to include directives

on how the fund manager decides which assets should be considered for sale, in order to meet redemptions.

A conflict may occur with exiting investors preferring that the fund attempts to sell the most liquid and marketable assets so as to pay them most quickly. The fund manager is likely to be concerned about continuing the fund and may consider the most liquid assets also to be the strongest assets in the portfolio. The fund manager has a duty to consider both redeeming and non-redeeming investors. Best practice would suggest that the fund manager should sell a blend of assets that is representative of the entire portfolio to deal with any redemptions, thereby treating redeemers and non-redeemers in a similar manner. This could mean selling some liquid and some less liquid assets.

The fund manager should recognise that when operating an open end fund there could be redemptions on the portfolio at some point in its life, and that therefore the level of liquidity required in the underlying portfolio may mean that such a fund is not appropriate for certain - eg non-core - strategies.

**Prioritisation of fund expenditures**
The fund documentation should describe how the manager will prioritise fund expenditures such as capital expenditure (capex), redemptions and income returns. This policy should be aligned with the fund's intended level of liquidity and investment strategy.

**Lock in periods**
At the launch of an open end fund, investors should expect to be locked in for a period, to allow for the fund's growth and to offset some of the set up costs. The lock in period may vary depending on the type of underlying assets, but a period of two years would seem reasonable.

**Redemption caps**
Open end funds may justifiably place limits or caps on the amount of redemptions that can be made on a quarterly or annual basis. These limits may be defined as a percentage of fund NAV, or a fixed monetary amount.

**Queuing mechanism**
Managers should be clear on the mechanisms to be used when dealing with redemption requests; whether, for example, there is a formal queuing system, or a set date by which all redemption requests received over a specified period will be dealt with. The mechanism should be clearly documented, including whether the order of investor repayment is pro-rata or "first past the post".

## Establishing terms for acceptance of transfer of rights

Fund managers should be aware that some investors may wish to sell their units on the secondary market. This should be considered acceptable, as long as the potential purchaser will not prejudice the nature of the fund by their investor status.

> 'The fund manager has a duty to consider both redeeming and non-redeeming investors.'

There may be some merit in the manager talking directly with such an investor with the possibility of their exiting the fund through a secondary transfer, with the potential purchaser buying their units at, or above the prevailing redemption price. The redeemer should not be placed under any duress to make this kind of trade, but should be provided with the opportunity.

The manager may fund redemptions from cash generated by the fund (through asset disposals and/or income), by increasing current debt (within agreed levels), and also by seeking purchasers of units at or above the redemption price. Should purchasers only be willing to pay below the redemption price, the redeeming investor should not be under an obligation to accept this price.

## Establishing a process for conflicts of interest

The fund documents should clearly state the process to be followed in the event of a potential conflict of interest caused by a redemption request. The term 'conflict of interest' refers to a situation where a conflict arises for an individual or a group of associated individuals with another competing

interest. This procedure should help to ensure that any actual or reasonably perceived conflict will be managed in an appropriate manner and be disclosed in a transparent way.

An example of such a conflict would be where a fund manager has been served with a redemption request, but at the same time has continued purchasing assets or undertaking capital expenditure, yet is unwilling to meet the redemption request. In such a situation there is clearly a difference in standpoint, which the documentation should provide for. Terms could be included such that, the existing business plans agreed at the beginning of the year (say to undertake certain capital expenditure) should take precedence over any redemption request, and be carried out. In this case provisions should explain how the outstanding redemption request is followed up on. On the other hand, potential new capital expenditure and acquisitions should not be considered if there are insufficient monies to meet existing redemption requests.

# Section 2

## Creating access to secondary market trading

# Creating access to secondary market trading

> ‘In markets with established secondary trading structures, best practice would be that investors have the ability to trade units via the secondary market’

The constitutional documents should include all the information needed for the fair and equal treatment of investors in terms of secondary transfers. According to the INREV Guidelines “constitutional documents should provide a clear legal and regulatory framework as to how such secondary transfers should be conducted”. Investors need to understand their rights, obligations and possibilities regarding secondary market trading, together with the responsibilities of the fund manager in this area. A deficient understanding of common concerns can lead to shareholders playing a lone hand and acting against the fund’s interest.

In markets with established secondary trading structures, best practice would be that investors have the ability to trade units via the secondary market without the fund manager’s approval, unless the potential investor is not permissible due to the structure of the fund or for legal reasons.

**Auction services and fees**
The fund manager may wish to assist with such trades, via an auction service, or more likely linking up with a secondary market broker. If an auction service is available then clear terms of reference are required. For trading through a secondary market broker, or if the fund manager itself provides a secondary market service, any fees for administrative tasks, such as re-registering traded units, should be clearly disclosed along with the policy implementation. Guidance on fees chargeable by secondary market brokers and fund managers for secondary market transfers should be based on the value of the trade and agreed in advance. Fund managers should also be transparent on the methodology for income apportionment on secondary market trades and the registration of units in the trade. With most funds distributing dividends quarterly or monthly in arrears, registration dates should be in line with subscription dates, to enable the fund manager to apportion income clearly between the vendor and purchaser in the trade.

Further, the fund documents should clearly describe any matched bargain service offered by the fund manager or an assigned third party, in particular regarding the related costs. Details of the related fees should be transparent and unequivocal, with any side agreements and divergence of conditions eliminated to avoid grey areas.

**Disclosure**
The fund manager should be prepared to provide secondary market brokers and potential investors with the relevant fund documentation to allow sufficient information to be available for such trades. The emergence of secondary market brokers has added depth and liquidity to transactions in property funds; fund managers should therefore be prepared to assist with their enquiries on secondary market trades, unless they believe they are of a spurious nature.

**Authorisation**
The fund manager/secondary market broker needs to have received clear authority from the purchaser and vendor that they are able to undertake the trade, for example with regard to having sufficient monies available and that all relevant Know Your Customer (KYC) procedures have been undertaken. It is imperative that secondary market participants have the required approval of their investment committee or other internal personnel to undertake the trade. Such trades may require Sale & Purchase Agreements (SPAs), as they are Over the Counter (OTC) rather than screen based, though this may not be mandatory, as in many cases the parties are well known to each other and the stock and cash will be moving simultaneously on the settlement date.

**Notification**
A vendor of units in a fund, that were previously placed in the redemption queue, will need to notify the fund manager of the trade, as the

> ‘The emergence of secondary market brokers has added depth and liquidity to transactions in property funds’

redemption notice may not be extinguished when the unit is sold; the new purchaser may therefore find themselves holding redemption units. The fund documentation should clearly disclose the position regarding units that are being redeemed and the use of the secondary market; as the manager may also use the secondary market to reduce a redemption queue on its fund.

**Pricing process**
Enabling secondary trading is very important for open end funds.[2]

A clearer understanding of the pricing process may be useful to all parties (including buyers, sellers, managers, advisers, platform providers and fund administrators), thus smoothing the path to more widespread and efficient secondary trades.

Some of the benefits include:

- Investors can exit strategies that have drifted from their original mandate
- Facilitates portfolio rebalancing
- Investors in open end funds can spend less time queuing for redemptions or subscriptions
- Improved governance by reducing the number of manager relationships
- Opens up possibility of buying at a deep discount (or selling at a high premium)
- Increases liquidity for investors

**Introduction to pricing of units**
Five general observations can be made on pricing:

1. The secondary trading model can vary from country to country and so can the approach to pricing[3]. There is no single approach that works for everyone every time.
2. The secondary trade can be done at any price that the buyer and seller agree. It does not have to be set as a certain prescribed margin above or below NAV; in fact, the price of a secondary trade does not have to be anchored to NAV (although in practice it usually does). Approximately 89% of trades occur at prices other than NAV.[4]
3. The current unit price will have a material impact on any secondary market price. Even in those situations where the price is determined using non-NAV methods such as cash flow forecasting, the negotiation over price usually begins with the latest available NAV.
4. Secondary trading means that investors in open end funds can spend less time queuing for redemptions or subscriptions. Nobody likes queuing, and queuing has an opportunity cost, whether that is caused by waiting too long to buy a desirable asset or waiting too long to shed an undesirable one. A fund with a significant subscription queue may see secondary market transactions occurring at a premium to the offer price. Conversely, if an investor who wishes to exit the fund is near the back of a redemption queue, they may be willing to accept a discount to the prevailing bid price. The length of the queue, whether it's a queue to get in or to get out, has a direct impact on how the units are valued. Managers should give reliable indicators of queue times.

A secondary market transaction can range from a simple agreement at an agreed price to a complex structured arrangement, for example involving deferred payments. A transaction in a core open end fund should be a relatively simple transaction, the only complication perhaps being to account for distributions payable. A transaction in a private equity style fund may, however be, much more complicated.

**Different approaches to valuing units**
As noted in point 1 above, there is no single approach but rather a continuum that ranges from using the current unit price without further analysis to detailed, bottom up forecasts on an asset-by-asset or even lease-by-lease basis.

**2** The benefits are described in INREV's 2016 report called Secondary Trading and Liquidity

**3** See INREV Guide to Secondary Trading, February 2018, page 11

**4** Source: PropertyMatch trading history, 2009 to end 2017

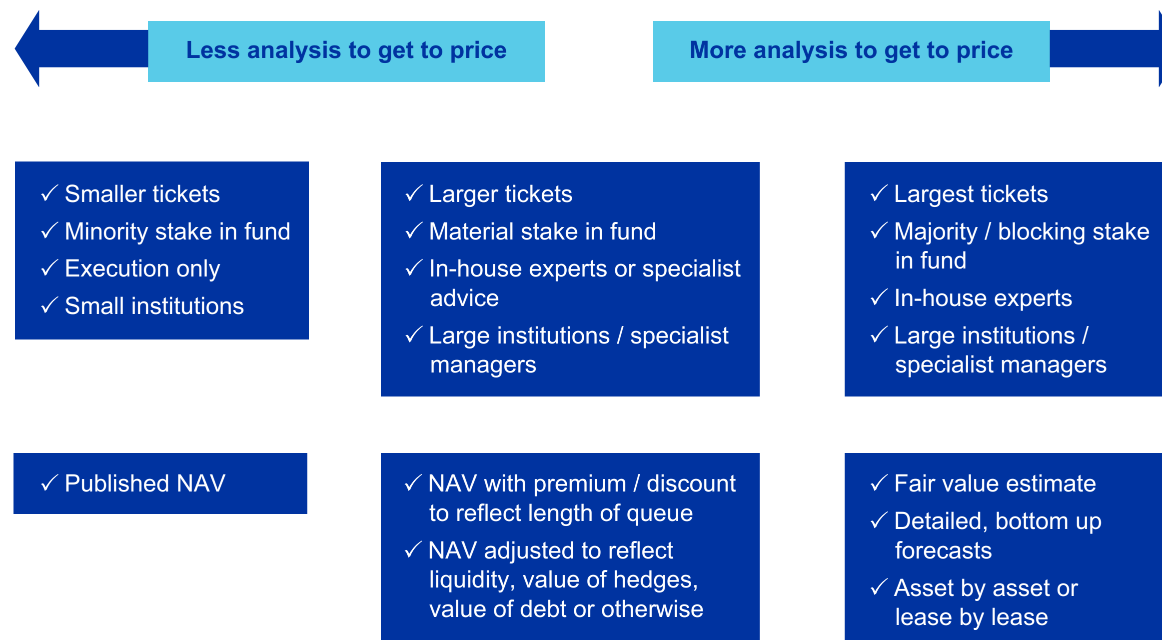
**When are the different approaches employed?**
It depends on many factors, one of which may be the size of the deal ("ticket"). Other factors are the resources available (whether in-house or external consultants), the strategic nature of the deal and the time available.

**Ticket size**
Very small deals can be done via the subscription and redemption process, or possibly through an execution only secondary trade (that is, with no advice). Such deals may be finalised at latest available NAV, with no adjustments. The question of who is entitled to distributions may be overlooked. Distributions often flow to whoever is registered as unit holder at quarter end.

**Figure 2: Ticket size – indicative ranges – broad brush only**

| Deal size | Comments on approach |
| --- | --- |
| <2m: | Redeem/subscribe (or possible an execution only secondary trade) |
| 2m<>50m: | Advised secondary trade |
| >50m: | Corporate finance approach, with bespoke representations and warranties |

**Figure 1: Broad brush illustration of the range of valuation approaches**




**Governance budget**
It may also depend on the governance budget of the investor (that is, how much time and expertise the investor can apply). Expertise in this sense means either in-house expertise (for example, in the case of specialist secondary managers, fund of fund managers and large investors) or bought-in expertise in the form of advice from consultants.

**Strategic deals**
The most detailed valuation approach is often associated with a restructuring or strategic change of a closed end fund, but it could also be applied where a significant stake in an open end fund is in play. The governance aspect in these situations is substantial. The skill set required for this approach is a mix of hands-on, asset level expertise (such as a valuer might have) coupled with the ability to value the other assets in the portfolio.

**Timeframe**
The full process has four steps:

1. Data gathering
2. Analysis and valuation
3. Negotiation
4. Completion.

The entire process can take anywhere between a few days and several months. If time is of the essence then a very detailed, bottom-up approach is more challenging.

Big ticket deals involving multiple parties (e.g. one seller, many buyers) will take longer than simpler one-on-one transactions. A formal selection process might be necessary if the interest greatly exceeds the amount available to transact. If the process drifts over a quarter end then numbers may need to be adjusted to reflect the most recent available information.

**Examples of sophisticated valuation approaches**

Some participants take the view that NAV is an accounting value and is not necessarily ideal for valuation or pricing. Participants such as these may prefer bottom up forecasted cash flows over the investor's likely holding period. The estimates are based on each asset in the portfolio, so it does not work with blind pools; it is also labour intensive for mature open end funds that hold extensive portfolios. For open end funds, the bottom up approach may be applied to the biggest assets in the portfolio rather than all the assets.

The investor will take a view on the value of all debt and hedging instruments, possibly using their own data feeds from those banks selling the hedging instruments. Estimates may factor in future fees, taxes and currency movements (though these are very uncertain). The participant will also take a view on operational issues and expenses.

The work involved in doing such bottom-up forecasted cash flows will reflect factors such as:

1. Number and complexity of assets in the portfolio

    a. Multi-tenant assets are more complex than single tenant assets

    a. Retail and office are generally more complex than residential

    c. Rent reviews are more predictable in certain jurisdictions due to national law

2. Manager's willingness to share data

Valuation may also be based on adjustments to a fund specific NAV. Market participants may be agnostic on whose NAV it is (INREV or other). In a similar vein, they can cope equally well with open end funds that use either classic dual pricing or Cap & Am[5] priced funds.

**Concluding remarks**

Overall secondary trades are expected to continue to grow because:

- investors are more willing to actively manage their holdings

- the non-listed real estate market continues to grow

- more capital is being raised for specialist secondary funds

- there are more brokers in the market

Having a better understanding of how units are valued should make it easier for buyers and sellers to agree on price. For managers of open end funds, it is clearly easier to have investor cash flows take place on the secondary market, because this requires no asset-level purchases or sales. The advantage is more marked when the underlying markets are less liquid than usual.

**5** Capitalisation and amortisation. For more details see https://www.inrev.org/news/inrev-news/open-end-fund-pricing-first-conclusions

# Section 3

## Establishing and publishing a fair price

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# Establishing and publishing a fair price

In an ideal market, valuation methodologies would be harmonised in a way that allows for the reflection of prevailing market conditions, to a frequency that allows portfolios to be closely tracked. This would likely lead to increased confidence and liquidity in open end funds.

The INREV Guidelines' principles on pricing mechanisms state that the "terms and pricing of a new equity issue should be fair to both new and existing investors," indicating that this is a potential source of conflicts of interests between the parties involved in a fund. To prevent any such conflicts, the fund manager is encouraged to disclose all relevant information, as elaborated on in the following, and set up a governance framework which provides for appropriate mechanisms and disclosure requirements in relation to the frequency and methodology of pricing.

So that a lack of transparency does not act as a barrier to exit or entry, an open end fund's constitution should include the following aspects:

**Disclosure of the valuation methodology**
A consistent valuation methodology for all material assets and liabilities needs to be in place and clearly communicated, with any variations explained. The documentation should also clearly state all the major assumptions underlying the valuations, to ensure auditability.

**Pricing methodology**
The fund manager should carefully consider the pricing methodology to be used and disclose clear information about the underlying calculations, to ensure investors fully understand the values presented. As differing fund prices imply varying interpretations of value, the intended purpose behind every price should be clearly stated alongside its definition and calculation methodology.

To avoid ambiguity, the disclosed prices should be clearly defined, stating whether the price is ex div or cum div, whether the NAV includes or excludes performance fees, and the accounting standard to be used. In the following paragraphs, commonly disclosed price formulations are described and distinguished.

**Net Asset Value (NAV)**
NAV is the total market value of all of a fund's assets (including cash and indirect property investments) less that of all its liabilities, net of all fund management fees. Each fund's NAV should be calculated on a basis which is consistent over time and should be detailed in the fund's own constitutional documentation, to allow investors to understand differences in NAV calculations between funds. It is a common practice in the industry to base redemption pricing on NAV, and to deduct an amount representing the hypothetical costs for disposal of the assets. This may be difficult, as it is unlikely that any fund which is forced to sell its assets will be able to achieve the estimated book value at that time. Indeed, it is widely recognised in the industry that the use of NAV as a pricing or valuation mechanism can inflate the unit price. Selling an asset at times when numerous assets are coming onto the market may also result in a lower price than that at which it has been valued.

'The intended purpose behind every price should be clearly stated alongside its definition and calculation methodology.'

**Frequency**
To avoid conflicts of interests between existing and new investors, the fund constitution should prescribe the frequency of pricing - at least on a monthly or quarterly basis - to provide information about possible conditions for subscriptions and redemptions. The scheduled date for which the unit price is to be provided should be clearly communicated to investors and should be unchanged throughout the fund's life. To be of value, especially for international investors who might be used to working with different measures of value, it is very important that the underlying valuation process is disclosed in the fund's constitution documents.

## Publication of pricing

The INREV Guidelines principle states that 'Confidentiality arrangements over fund documentation should not, where possible, prevent the development of secondary market transactions.'

Arrangements concerning the disclosure of asset information may prevent a potential new investor from being able to do proper due diligence research on a fund. Related provisions should maintain confidentiality and at the same time balance the need to ensure transparency; if there is a conflict, the need for transparency should prevail.

# Section 4

## Disclosure to potential new investors

# Disclosure to potential new investors

The fund constitution should provide for a transparent investment vehicle that gives investors access to all the information they need to assess the performance and quality of their investment, allowing them to make reasonable decisions about retaining or disposing of their holding, as well as enabling secondary market trading. This basic rule was expanded earlier in this document. A balance should be struck between full transparency for investors and confidentiality for commercial purposes, as well as the protection of the various parties.

**Confidentiality agreements**
Confidentiality agreements that address the accessibility of sensitive information for potential new investors should be fairly discussed, taking account of different standpoints relating to each individual vehicle framework. Fund documentation should deal with two key aspects of confidentiality: Whether investors are bound by a confidentiality clause, and whether the manager is bound by confidentiality restrictions.

**Standard non-disclosure agreements**
The liquidity module of the INREV Guidelines states that “potential new investors should have access, subject to signing a standard non-disclosure agreement and with the consent of existing investors, to the same information as existing investors with respect to the vehicle’s constitution, activities and performance”. Fund managers commonly face the problem that existing investors do not consent to provide potential new investors with all the information they would like to obtain for their due diligence. To prevent conflict between these two standpoints, the fund documents should clearly state the type of information to be made available and also the type of information to be withheld. It is however generally agreed that transparency is critical in allowing for liquidation and secondary trading. In all types of funds, managers should carefully follow the provisions to ensure that there are no breaches of the agreements and that it is acting in the best interests of all investors at all times. Should a situation arise that is not covered by the fund documentation, there should either be a process of consultation with the investors or, if specific powers need to be granted to the fund manager, amendment to the fund documentation (without unanimous consent) to provide for this.

Good governance is demonstrated by the equal treatment of all investors, who should be bound by the same confidentiality clause. The clause should be contained in the fund’s marketing material and subscription document. Clauses that only relate to a group of investors should be avoided in order to prevent conflicts arising from disparity. By the same token, the investors may wish to bind the fund manager with confidentiality restrictions, for example on due diligence with regard to clients. Here again restrictions should be universal rather than made in response to individual requests.

> ‘Transparency is critical in allowing for liquidation and secondary trading.’

# Section 5

## Respecting local customs

# Respecting local customs

The previous chapters described how a framework for an open end fund could be built to enhance liquidity and support access to secondary market trading. However, local customs and regulatory conditions may limit the possibility of open end funds implementing such a framework in different parts of Europe. This regulation may have been introduced as a consequence of the financial crisis, so that investors are less likely to find themselves unable to liquidate their holdings and open end funds are better able to honour their agreements to make redemptions.

**European regulation landscape**
The European environment is strongly influenced by country specific regulation, a factor that has often prevented the establishment of common market behaviour. The liquidity module of the INREV Guidelines addresses the topic from a European viewpoint and therefore addresses the level above that of country specific regulation. The Guidelines stress transparency and fair liquidity mechanisms for remaining, exiting and new investors as essential for the exercising of liquidity rights, but do not elaborate on how to translate these principles into funds' governance structures.

As one of the most mature and professionally developed markets, best practices in the UK are considered as a base reference point for this paper. In this chapter these practices are compared to those common in the Netherlands, Germany and Luxembourg. The nature of the UK market is also reflected in the results of the INREV study on real estate liquidity, with UK investors and multi-managers ranking liquidity as more important than investors from any other location. German investors, predominantly comprising insurance companies and defined benefit pension schemes, are the least focused on liquidity but the most concerned with income return. This reflects the fact that these investors typically have very long term investment horizons.

## United Kingdom

Within Europe, the UK is considered the most mature market in terms of secondary market trading and its best practices in this field are well established and serve as a role model for other markets.

An open end fund is typically defined as one where - assuming normal market conditions - investors can liquidate and receive settlement for their investment within 12 months of serving a redemption notice, and in extreme conditions within 24 months. It is generally assumed that if more than 75% of unit-holders serve a redemption notice that is de facto a notice to wind down the fund, which the manager should effect, within two years. The exact conditions should be determined in the fund documents.

> 'The European environment is strongly influenced by country specific regulation, a factor that has often prevented the establishment of common market behaviour.'

**Access to secondary market trading**
Transparent market behaviour and clear communication are critical in establishing a mature market. The fund's constitutional documents include comprehensive redemption terms and processes are in place to navigate situations of misalignment, between the fund manager and investor.

The level of secondary market transactions is made possible by a number of agencies and market brokers in the UK. One of the key reasons for the growth in the secondary market has been the ready availability of market and fund data, with clearly established pricing mechanisms.

**Pricing methodology and valuation**
The following prices are generally quoted on a monthly or quarterly basis for open end funds in the UK:

- Offer price: The offer price includes the prevailing NAV plus estimated purchase costs incurred in the purchase of the properties in the portfolio; broker costs, legal costs, VAT and any property costs on purchase, such as Stamp Duty Land Tax (SDLT). The offer price will therefore be wider for a leveraged fund and will be narrower for a fund that holds cash, as no purchase costs should be reflected on the cash element of the portfolio.

- Mid-price: The midpoint between the offer and bid prices.

- Bid price: The NAV less the estimated selling costs of the property in the fund. The spread between the NAV and bid price will be narrower for funds that have non property investments on their balance sheet, such as cash. The bid-offer spread (or bid-ask spread) is calculated as the difference between the latest bid and offer prices expressed as a percentage of the latest offer price.

Ideally the fund should also provide an INREV NAV price that amortises purchase and loan breakage costs. However this cannot currently be considered to be the norm in the UK. In practice the INREV NAV is not used for pricing, albeit it would be preferable for standardisation purposes, if this were the case, across Europe.

**Disclosure**
Disclosure of pricing and valuations is not compulsory by regulation, but it is common practice to make the relevant information publicly available. Pricing is often disclosed in major financial newspapers such as the Financial Times and on the fund manager's internet site; at the same time existing investors should automatically receive an email from the fund manager stating the published price, unless the purchaser has decided to prohibit publication.

## The Netherlands

The Dutch market is similar in many respects to the UK in the context of open end fund liquidity. As the types of participants in these two markets are alike - investors, managers and brokers - standards in these markets have converged, with Dutch practices moving closer into line with those in the UK. However, there are a few areas where the Dutch market deviates from the UK in terms of open end fund liquidity, relating principally to secondary market trading, pricing methodology and disclosure. In some cases disparities also stem from local tax regimes, which are briefly outlined at the end of this chapter.

**Access to secondary market trading**
Secondary market trading is less advanced in the Netherlands than in the longer established UK market. Although secondary trading is not uncommon, it is less frequently used as a means of providing liquidity. This is a consequence of the size of the market and the limited degree of standardisation in liquidity policies and procedures. For many non-European investors, the UK is their first port of call once they decide to invest in Europe, and therefore the UK market attracts a much broader level of participation, enhancing the potential for secondary market trading. In many Dutch funds - especially those set up before the global financial crisis, which tend to be dominated by local investors - there is no clear statement of rights and obligations in the constitutional documentation. As a consequence of this relative lack of standardisation in the Netherlands, secondary trades are more frequently organised by the manager, rather than through a secondary broker or platform.

**Pricing methodology and valuation**
In terms of pricing methodology and valuation there seems to be less standardisation in the Netherlands. Valuation in UK funds is typically carried out in accordance with the RICS Red Book valuation standards, while in the Netherlands there is more diversity when it comes to valuation standards and valuation frequency. In addition the UK market's volume and depth supports more rigorous valuation changes, whereas the Dutch market appraisals tend to be more smoothed and therefore typically lag the true level of property prices, making the reported NAV's less robust. In addition, the Dutch market is smaller and will thus offer less pricing comparisons, leading to larger bid-ask spreads.

An additional difference in comparison to the UK is the transparency level of the Dutch market. Publicly available information in the UK is not only more common, but also more meaningful. In the Netherlands potential investors are given less insights and publicised information is often too tenuous to be considered sufficient to form a substantiated (investment) decision. Eventually this lower level of transparency, vis-à-vis UK, makes it more difficult for investors to assess an investment fund, as they would at least need access to the annual report.

To summarise the lack of standardisation and transparency lead to less confidence on the

investor side. Consequently, investors have some difficulty in forming their own opinion on pricing (reporting, placing documents, seller's capital account statement etc.). In a proprietary setting, the price will be determined between the buyer and seller. For actively traded funds in an efficient market, the market will determine pricing. Pricing could be different in a redemptions or issuance process through the manager, in accordance with the prospectus and in those cases can be adjusted for eg set-up costs, possible acquisition costs and a manager fee.

**Disclosure**
Generally disclosure in the Netherlands is fairly limited and typically only accessible to existing investors. Providing commercial data to the general market through eg fact sheets, quarterly or annual reports is uncommon. The offering of units in open end funds is subject to certain prospectus and information requirements under Dutch law. Yet if the units are offered exclusively to professional investors the regulatory requirements are more limited. Due to this lack of transparency prospect investors will find it more difficult to come to a well-founded view on pricing which will impact pricing and/or liquidity altogether.

**Regulatory compliance**
There are some additional matters relating to tax which impact liquidity. Firstly some forms of partnerships or mutual funds are transparent for tax purposes for which the admission or replacement of LP's are subject to the prior written consent of all existing partners or unitholders. This is the case for redemptions and/or secondary market trading for 'closed Commanditaire Vennootschappen' ("CV") and secondary trading in relation to 'Fondsen voor Gemene Rekening' ("FGR"), i.e. mutual funds. A FGR or mutual fund which only allows for liquidity through a redemption mechanism is not subject to full shareholder's consent. In addition to using tax transparent vehicles as described above, real estate funds (BV, NV or FGR) can also be structured as 'Fiscale Belegging Instellingen' ("FBI), the Dutch version of a REIT, where several shareholder restrictions may apply in order to benefit from this status.

## Germany

Looking back at the institutional non listed real estate market in Germany during the past decade and the financial crisis then illiquidity could be considered one of its main characteristics. Being only little institutionalised and demonstrating strong shareholder relations secondary market trading was hardly seen. The number of funds that are active on the secondary market and therefore the number of transactions is limited, so that the market today is still in an immature stage and common market practices have not been be established. In addition to the immature market, a major element of investors follow a so called 'buy-and-hold strategy,' which is characterised by long term investments and ignores any preterm exit opportunities. Still today it seems that German market players do not prioritise liquidity when investing in real estate. The financial crisis appears to have even strengthened this position; apparently liquid investments have proven too illiquid as redemption requests could hardly be fulfilled.

> 'Is the German market showing more interest into its associated market opportunities?'

Is the German market showing more interest into its associated market opportunities? Or are these only myths that reflect the market before the financial crisis, but are not applicable in the current circumstances? It has been noticed that more and more investors do move away from this conservative buy-and-hold strategy for their investments and attribute greater importance to solutions that offer more flexibility and liquidity. Clearly income distribution remains the decisive factor for decision making and prevails above capital growth return, simply for the reason that accounting only recognises realised accretion.

A second myth in relation to the allegedly dominate view of a 'buy-and-hold strategy' is that the *Verkehrswert* is preferred over current market value. The *Verkehrswert* in theory equals market value, but very often is modified to a more stable value that does not show the same volatility as a 'real' market fair value. When looking at today's reporting customs it can be seen that this is not the case anymore.

At first glance the German market might still suggest a very conservative picture, blocking out any activity on secondary markets, but especially institutional investors clearly operate strategically and do not blindly follow the buy-and-hold strategy. Main drawbacks of this advancement are first of all that valuations do not reflect realisable market fair values and secondly the market's impenetrability. Entering a secondary market scepticism is high if prices are appropriate, as the underlying communication and data exchange is missing fundamental transparency to create a reliable setting. In the UK on the contrary the unit price is well established and investors refer to it with confidence, only negotiating around discounts and premiums.

**Access to Secondary Market Trading**
Taking the rather immature state of the secondary market in Germany into consideration it is not surprising that the majority of fund documentation does not include a clear framework for the effectuation of secondary transactions and the allocation of responsibilities for the different aspects of the transfer. When setting up a new fund it is advisable to address secondary transfers in the fund set up stage along with other important aspects of the fund, such as liquidation, voting etc. Treatment of side letters and other restrictive clauses should be embedded and clearly regulated. The fund documentation should disclose clearly the position on units that are being redeemed and the use of the secondary market; as the fund manager may also use the secondary market to reduce a redemption queue on their fund. The fund agreement additionally should be clear on constraints of admitting third parties into the fund to service redemption requests, as this is also subject to restrictions of the German Federal Financial Supervisory Authority ('BaFin').

An inclusion of an extensive framework at fund initiation will diminish gaps in the constitutional documents that could possibly lead to a mis-alignment of the funds' parties in a later stage of the investment. Adding regulation into the established documents is practically impossible, as it would require consensus from all involved parties. Nevertheless, a non-existent framework in the fund documentation does not mean that that secondary transactions are not possible anymore, as existing agreements only rarely are restrictive in this area.

**Pricing methodologies and valuation**
Due to German regulatory requirements in the *Kapitalanlagegesetzbuch* the official pricing methodology should be on the basis of the *Anteilswert*. However to be consistent with European practice and to be accessible for international investors, then disclosures should include the INREV NAV and/or at least all information needed to calculate INREV NAV, for example disclosure of fair value of debt. Pricing for transactions between (potential) investors need to be on a negotiated basis for semi open end funds with no (workable) liquidity mechanism through redemptions, as *Anteilswert* is often not a proxy for true (market) value.

**Market valuation framework**
Furthermore a market valuation framework should be established for the issuance of new equity and redemptions in the articles of the fund (especially for new funds) to avoid regulatory valuation mechanisms leading to a potentially too conservative value, such as the Anteilspreis. Valuation and the determination of the share price used for transferring shares in German open end funds has historically been and remains today a major detriment to fund liquidity. Property is valued according to German Verkehrswert under German KAGB fund regulation. That being a given leads to a lack of working redemption or secondary market mechanisms as investors (rightly) fear redeeming too cheaply or entering existing funds too expensively. The fund valuations often do not serve as a good starting point for secondary trading negotiations, as there is a lack of belief among institutional investors that these numbers reflect the true value of their holdings.

Moreover, all non-real estate items on a fund's balance sheet are at nominal, not market or fair values. The INREV NAV concept is not widespread in German *Spezialfonds* structures. To allow for proper secondary trading and for making redemptions and entries more efficient, fund best practice should move towards publishing INREV NAV in addition to the official share price. Valuations should become more market-oriented and valuers have to adapt to relevant valuations methodology – especially for non-German real estate in German fund structures.

Current market practice are annual external valuations that are divided into monthly share prices on a rolling basis.

**Disclosure**
This is one of the key points in Germany. Institutional German *Spezialfonds* have the possibility to publish their share prices in an open portal – the *Wertpapiermitteilung* – however as the information is publicly available, it is not widely used. As most funds are non-discretionary, investors have tended to stay in the clubs or pools formed at the time of the funds' initiation. Guidance on the provision of information (under NDA) should enter new funds' documentation. KVGs should state openness and commit to providing information to new investors. No general confidentiality hurdles that prevent availability of liquidity should be stipulated in the fund documents.

The German market faces its main issue regarding transparency when it comes to the standardisation and publicly available valuations. Especially if "old school" German *Verkehrswert* as provided by the *Sachverständigenausschuss* is still used by the fund or fund manager. All valuation assumptions should be provided to investors and potential investors, to allow for pricing discussions on a value closer to market. All non-real estate items enter the funds' balance sheet at nominal value, not fair value according to German Investment Accounting Principles. Thus, information regarding the fair value of these items (especially debt, at least interest rates and duration of the loans should be provided) needs to be provided by the fund manager. Replacement partners should have access to all relevant information to be put into a situation to do a comprehensive underwriting of the LP interest. Information should be provided subject to a pre-agreed NDA. The GP must be informed and have transparency over the flow of information and become a beneficiary of the NDA so as to be in a position to exercise damage claims for the fund, in case of a breach of confidentiality.

**Regulatory compliance**
In Germany insurance-regulated investors in open end funds in generally face various legal requirements they need to adhere to, approval by KVG is necessary, but should only be able to deny consent for "important reasons".

## Luxembourg

The market for open end, European Funds registered in Luxemburg is well established, with a deep pool of funds, many having operated out of Luxemburg for over ten years. The best liquidity is found within the pan European, multi-sector funds which offer the most liquid open end terms, whereas the country or sector focused funds will tend to be closed or semi open ended with limited liquidity.

**Access to secondary market**
The secondary market for open end funds registered in Luxemburg is not as developed as the UK, with far fewer trades as a result. The market has seen good progress over the past five years as a number of the agencies and brokers have started to cover the region, however there is a shortfall in the information and disclosures that have hampered secondary market liquidity.

As well as the agencies and brokers most of the open end funds will offer some liquidity, generally via a matched bargain process run internally.

**Pricing methodologies and valuation**
The market has seen a significant shift towards open end funds pricing at NAV for valuation and subscriptions or redemptions, rather than pricing off a bid/offer spread. An open end fund launching in the past five years would typically price at NAV, whilst older vintage funds with a bid/offer spread will have converted or are looking to convert to NAV pricing, being a single price.

The bid/offer spread pricing takes some of the transaction cost into account when investors enter or exit a fund by reflecting the cost of selling a building to fund a redemption for example, and compensates the remaining investors in the fund.

Alternatively a Fund pricing at NAV would usually amortise any transaction costs over a number of years, typically five years. This system is akin to attaching the transaction costs to the life of the underlying investment, rather than compensating exiting investors for the costs associated with transactions made on the back of new equity entering the fund.

The NAV pricing method also has the effect of increasing primary market liquidity as there are less “up front” costs associated with entering the fund. Conversely it reduces the secondary market liquidity as investors do not have the ability to agree a price between bid and offer, which is advantageous to both the buyer and seller of units in a fund.

There are benefits and risks to both methods of accounting for transaction costs. The straight NAV pricing model offers a cleaner approach where all investors are subject to the same terms. Whereas with the bid offer approach it may not always be appropriate to charge an entry fee. If, for example, the capital being called will be used to paying down debt or for capital expenditure, in these cases there will be significantly smaller transaction costs, as compared to buying a building and it might be appropriate to reduce the entry fee (where the fund documents allow) but this would not be seen as offering the same terms to all investors.

Most open end funds will offer quarterly liquidity with settlement within a number of weeks, subject to a deferral period to help the management of cash and to prevent forced sales. The deferral period would typically be for one to two years. There is a balance to be found between servicing the exiting investors while not putting the remaining investors at a disadvantage. It is normal practice for the manager to be required to make “best efforts” in creating liquidity, and ideally the fund would be restricted from making new purchases, while there are outstanding redemptions.

**Disclosure**
The frequency of NAV reporting is either monthly or quarterly, but it is not compulsory to be published. Funds will either publish pricing on an investor portal or distribute via email. These email distribution lists are tightly controlled by the Luxemburg administers. Similar to the UK, a fund would be considered open ended if in normal market conditions; investors can liquidate and receive settlement for their investment within (for example) 12 months of making a redemption, and in extreme conditions within say 24 months. The assumption should be that if greater than 75% or a substantial majority of unit-holders were to serve a redemption notice, then that is de facto a notice to wind down the fund in a period of normally two years, which again should be determined in the fund documents to deny consent for “important reasons”.

## Switzerland

The market for Swiss real estate investment vehicles has grown substantially over the past 10 years. Even though the overall Swiss real estate market size by nature is limited, representing just about 1.5% of the global investable institutional market, there has been increased interest also by Swiss institutional investors driven by their strong home bias but also their need for recurring income in a very low and since Q1 2015 even negative interest rate regime.

As a consequence a large part of the growth came from Swiss institutional investors which are dominated by pension funds (AUM CHF >750 billion). Respective regulatory investment guidelines and restrictions (ruled in BVV 2, “Ordinance on Occupational Retirement, Survivors’ and Disability Pension Plans” or “Verordnung über die berufliche Alters-, Hinterlassenen- und Invalidenvorsorge” respectively) allow a maximum of 30% (thereof max. 1/3 abroad) of total assets for real estate. In average pension funds will have an allocation of 15 – 20%, the vast majority in Swiss real estate only, thereby clearly following a ‘buy-and-hold’-approach.

The investments in Swiss real estate predominantly take place via two types of vehicle structures. The first are investment foundations, adding up to approx. CHF 35bn AUM. Ruled in ASV (“Verordnung über Anlagestiftungen”), these foundations are only accessible for Swiss pension funds. Liquidity is offered on the primary market and determined by the respective foundation in its individual regulations. A common form is daily liquidity, however, depending on investment style it may vary (notice periods of up to 12 months or even lock-up periods). At the moment almost all foundations are closed for subscriptions, re-openings will be offered if there is a specific need for capital.

The latter vehicle structure are Swiss listed real estate funds, a Swiss specific structuring solution. The structure has proven to be crisis resistant so the launch date of some funds even goes back to the 40s of the 20th century. Especially over the past 10 years there has been a massive growth of the listed fund market, heading towards CHF

40bn capitalization value today. Ruled in CISA (Collective Investment Schemes Act) the funds by law feature annual valuation and a notice period of 12 months to the end of the business year to place redemption requests. For an improved level of liquidity CISA imposes the obligation that the fund management company has to ensure a regular exchange or off-exchange (OTC) trading of fund units. The majority of the funds is traded at the SIX Swiss Exchange in Zurich, the historical average of premiums is around 15 – 20%. Even though listed, the funds are not similar to REITS since the funds use lower levels of leverage with an average of 20 – 30% (the maximum leverage allowed is 1/3); in addition they do not build part of the equities universe and its respective indices and as a consequence are less volatile. The increased share of institutional investors among fund unit holders (estimated to be >40% today) have led to increased requirements with regards to transparency and reporting. While the high demand is certainly also the result of short capacity of the investment foundations the fact that the majority of the Swiss real estate funds are listed enables investors to adjust their exposure easily for tactical reasons which has added to the popularity of the funds among large market players.

**Access to secondary market trading**
For the investment foundations a free trade of units is not allowed (ASV art. 18). Most foundations will not allow any transfer of units, if at all then only with their involvement, thereby enabling the deal. This is clearly a limiting factor not only for existing investors but also for prospects.

As stated above by law there is the obligation for Swiss real estate funds to ensure an exchange (CISA art. 67) which for the vast majority today means a listing at the SIX Swiss Exchange to provide liquidity on units (largest fund >8bn CHF market cap, approx. CHF 90m traded per month). The consequence is that there is no broadly established secondary market trading beside the SIX. If funds are not listed then this is most likely because they have only recently been launched and are in the build-up phase of their portfolio. During this phase most funds derogate the obligation of an exchange (approval by regulator FINMA required) and as a result are not tradable and not deliverable. However, in some cases there may be a market maker providing bid and ask prices based on which the respective funds can be traded off-exchange.

**Pricing methodology and valuation**
The valuation of properties for both investment foundations and the funds takes place once a year by independent accredited appraisers; for the investment foundations a daily (or at least monthly) NAV is being calculated. The valuation follows a DCF approach which is very much Verkehrswert oriented. This leads to a smoothening effect and may cause a potential gap to mark-to-market pricing.

Redemptions will be based on the latest NAV which in the case of the investment foundations will be corrected for accrued income and liabilities for the year and often also a dilution levy of eg 0.25 – 2%.

**Disclosure**
Any open-end collective investment vehicle is obliged to publish an annual report within a maximum of 4 months after the end of a business year (CISA art. 89) containing, among others, annual financial statement, capital increases, acquisitions/dispositions, performance etc.

As for the exchange listed funds in addition respective specific rules of the exchange will apply (eg ad-hoc publication).

Also for investment foundations it is mandatory they publish an annual report within 4 months after the end of a business year (ASV art. 35). In addition, any investor may ask to be given insights in the administration of the business and accounting. Such a request may be rejected if there is a legitimate interest for protection or business secrets might be jeopardized.

## France

Whilst there is a large element of capital invested in open end property funds in France, these are principally for retail investors and there is currently limited capital invested in such funds for institutional investors.

With some exceptions, pension funds are not generally present in France. The most

common type of institutional investors is represented by insurance companies making direct investments in real estate. This is due to a limited number of international multi-managers and investment consulting firms focused on institutional investments. The institutional market is however more prevalent in the closed end property funds sector, which has been growing strongly over recent years.

## United States

Secondary trading in general is dominated by closed end funds. However, investors such as US pension schemes use secondary trading for open end funds, often to "queue hop" (that is, to skip any subscription queue). Historically, secondary trading was primarily used as a source of liquidity for investors, many of whom were High-Net-Worth (HNW) investors. However, the buyer universe expanded since the early and mid-2000s (with 2006 as the turning point) to include institutional investors such as endowments, foundations and public pension funds.

Secondary trades were driven in the past by investors' need to rebalance, but the market has matured and now the general partner of a closed end fund may embrace secondary trades (for example, via late life restructurings when a fund extension is being sought but some existing investors want out).

Deals can be done with third-party advice or without advice.

**Access to secondary market**
For closed end funds, the market is highly developed, but this is less so for open end funds, which is estimated by industry participants to account for less than 10% of total deal volume. In 2017, $6bn was traded in in closed end trades but possibly only $500m in open end trades. Nevertheless, some open end core diversified equity funds (usually abbreviated in the US to ODCE) have seen secondary trading activity. Nevertheless, there is no definitive data source for secondary trades and volume estimates can thus vary widely.

Secondary trading platforms which are familiar in Europe, are not a feature of the market in the US. There does not seem to be systematic adoption of or endorsement of secondary trading by the US open end funds, in contrast to the UK, where open end funds may actively encourage investors to use secondary trading rather than subscribing and redeeming units.

In terms of participants, the recent rapid growth has now become very broad-based, with pension plans, endowments/foundations, asset managers, family offices, insurance companies, banks and funds of funds increasingly using the secondary market as an important portfolio management tool. Several larger, high-profile transactions have helped to increase the visibility and validation of the secondary market. For example, in 2015 the California Public Employees' Retirement System (CalPERS) sold stakes in about 43 real-estate private-equity funds. The deal was worth an estimated $3bn and was undertaken following a strategic review. A change in investment strategy was also the driver for a significant secondary deal by Harvard Endowment in 2017, estimated to be worth $2bn.

The move to separate accounts by big investors makes secondary trading less relevant to them. Smaller deals attract less media coverage, and in the absence of any centralised trading platform it is harder to get data on completed deals.

**Pricing methodology and valuation**
Subscriptions for and redemptions of units in open end funds generally take place at NAV – with no bid/offer spreads and no redemption fees or penalties. It is a single pricing regime. This is in marked contrast to open end funds in Europe, where there are two pricing mechanisms traditionally used: the classic dual pricing model and the capitalisation and amortisation model. Both European mechanisms fit within the broad dual pricing category.

Each property should be appraised at least annually by an external, independent appraiser. Appraisals should be signed by a certified appraiser and prepared in accordance with the accepted standards. To maintain independence and objectivity in the appraisal process, valuation oversight is provided by an established, independent real estate valuation firm called either the "Valuation Consultant" or "Valuation Manager". Valuation of other fund assets and liabilities

like cash, debt investments and derivatives follows GAAP convention.

Open end real estate funds take a variety of legal structures, including limited partnerships and limited liability companies. The annual reporting requirements can therefore vary.

# Section 6

## Checklist

# Checklist

**Assess if your fund documentation is well prepared for offering a transparent, fair and liquid open end investment.**
**Does your fund documentation include the following?**

| | | Yes | No |
|---|---|---|---|
| | TERMS AND RIGHTS OF REDEMPTION | | |
| 1 | Definition of redemption window | | |
| 2 | Definition for period of serving redemption requests | | |
| 3 | Description of withdrawal process | | |
| 4 | Fund Manager's right to deviate from the redemption rules under special circumstances | | |
| 5 | Definition of special circumstances | | |
| 6 | Obligation of the fund manager to explain the special circumstances on the basis of which extensions/rejections of redemptions are made. | | |
| 7 | Definition of a threshold managers will be committed to sell off assets to meet redemption requests | | |
| 8 | Definition of measures if redemption requests have not been served in the agreed period | | |
| 9 | Description of fee reductions if redemption requests have not been served in the agreed period | | |
| 10 | Description of how assets to sell should be prioritised in order to serve redemption requests | | |
| 11 | Description of how fund expenditures such as capital expenditure (capex), redemptions and income returns are prioritised | | |
| 12 | Description of limits or caps on redemption requests per defined period of time | | |
| 13 | Description of the mechanisms covering redemption requests; eg formal queuing system, pro-rata system, first past the post | | |
| 14 | Description of the process of potential conflicts of interest caused by redemption requests | | |

**Does your fund documentation include the following?**

| | | Yes | No |
|---|---|---|---|
| | ACCESS TO SECONDARY MARKET | | |
| 15 | Description of investors' rights to access secondary market transactions | | |
| 16 | Legal and regulatory framework to conduct secondary transfers; Investor rights, obligations, possibilities, responsibilities of the fund manager | | |
| 17 | Description of internal approval procedure for secondary market trading, eg by investment committee | | |
| 18 | Where applicable, disclosure of fees charged for secondary market services, eg re-registering units traded | | |
| 19 | Where applicable, description of income apportionment methodology on secondary market trades and registration of units on the trade | | |
| 20 | Where applicable, obligation to disclose position on units in redemption and the use of the secondary market | | |
| 21 | Definition of matched bargain services offered by the fund manager/a third party; related fees should be transparent and unequivocal, disclosure of any side agreements and divergence of conditions (provided the fund manager has control over the appointment of third parties) | | |
| | VALUATION AND PRICING | | |
| 22 | Disclosure of governance framework which determines appropriate mechanisms and disclosure requirements addressing frequency and methodology of pricing. | | |
| 23 | Description of pricing mechanisms | | |
| 24 | Description of valuation methodologies | | |
| 25 | Description of calculation of (INREV) Net Asset Value | | |
| 26 | Define frequency of valuation and pricing and their disclosure | | |
| | DISCLOSURE | | |
| 27 | Distinction of information treated publicly or confidential in existing investor group | | |
| 28 | Disclosure of confidentiality clauses; in regards to both the manager and investors | | |

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