Real Estate Managers Face New Wave of SEC Scrutiny


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Real estate fund managers were among the myriad private fund advisers affected by changes to the SEC's registration requirements under the DoddFrank Act in 2011[1]. In the lead-up to the DoddFrank registration deadline in March 2012, and for many months thereafter, newly-registered fund managers faced numerous challenges when confronted with the reality of implementing an effective compliance program. Following the SEC's recently announced expansion of its exam program to focus on real estate fund managers, managers should now prepare for those programs to be put to the test — not just on paper but in practice.

Over the last three years, fund managers gradually adjusted to life in the new, regulated world as they familiarized themselves with the bulk of reporting and regulatory requirements. The volume of new registrants and the complexity of their business models prompted a similar engagement phase within the SEC, which responded actively by increasing the resources and training of staff at the Office of Compliance Inspections and Examinations ("OCIE"). As part of this response, OCIE launched a two-year "Presence Exam Initiative" involving focused, risk-based examinations of roughly one-quarter of the new registrants.[2] The preliminary results of that initiative were widely publicized in the "Spreading Sunshine" speech delivered in May 2014 by then-OCIE Director Andrew Bowden, who reported a 50% rate of compliance violations among private equity fund managers.[3]

These findings and other recent regulatory outcomes generated by the SEC continue to make headlines in the financial press, a fact partially attributable to the large sums of public and private pension funds involved. At the same time, political interest in tightened regulation of the financial services industry has shown few signs of abating since the financial crisis of 2008-2009. As a consequence, transparency is one of the key themes stemming from the SEC's recent efforts — the underlying rationale being that even the most sophisticated institutional investor cannot make educated decisions or exercise contractual rights effectively with respect to matters of which it is not adequately informed. However, some investors have also queried the importance of the SEC's findings and its perceived role in protecting institutional investors in the context of freely-negotiated management arrangements,[4] and some fund managers have expressed concerns over the preservation of legitimate confidentiality arrangements, upon which a substantial part of a manager's business may be predicated.

Having identified key regulatory concerns with the private equity model, and no doubt aware of the significant role played by real estate in any pension fund's asset allocation paradigm, OCIE is now bringing its new wealth of expertise and data to bear on the real estate sector. As OCIE turns its attention to real estate fund managers, this article outlines some of the common compliance concerns they may now face.

Compliance Program

In the rush of regulatory changes and last-minute amendments to SEC rules in 2011-2012, some fund managers implemented a "one-size-fits-all" compliance solution. Although these programs may check the right boxes, they are not tailored to the business of each particular firm.

From a resource standpoint, many fund managers appointed a long-standing executive as chief compliance officer ("CCO") and tasked additional reporting requirements to operational staff. However, one of the keys to an effective compliance program (and a successful SEC examination) is an adequately-resourced compliance staff. If the CCO wears other hats, the individual's operational duties should not detract from his or her compliance role. Typical weaknesses that may demonstrate a lack of resources include a lack of detailed documentation supporting policies, valuation changes and expense allocations.

Although some fund managers historically have seen regulatory compliance as an ancillary cost rather than a mission-critical business function, the SEC's Enforcement and National Exam Program divisions are now coordinating efforts to identify fund managers who lack effective compliance programs and procedures. This initiative has already resulted in 11 enforcement proceedings at the time of this writing.[5] Needless to say, such deficiencies (even if not rising to the level of enforcement action) can severely impact a firm's investor relations, its day-to-day operations, and ultimately its bottom line.

Annual Review

Registered investment advisers are required to conduct an annual review of their compliance policies and procedures (Rule 206(4)-7 under the Advisers Act). In practice, this review is often broken down into component projects that can be spread out over time and summarized in a report at the end of the year. The steps taken as part of the annual review should be carefully documented, and, at a minimum should:

- Test the comprehensiveness of your policies and procedures, taking into account changes in your business;
- Evaluate the effectiveness of the implementation of these policies;
- Identify compliance violations and remedial measures taken;
- Identify new compliance requirements and actual or contemplated changes to existing policies and procedures arising from the annual review; and
- Include a review of relevant issues by senior management.[6]

Annual reviews are another high-risk area that fund managers are frequently tempted to relegate to a checklist exercise or delegate to an external consultant, particularly if the CCO is distracted with more pressing operational tasks. But the annual review should be used for what it is: a serious opportunity to give your firm an internal scorecard and, at the same time, demonstrate to the SEC that adequate compliance resources are in place. In the modern era of complex regulation, a simple "all clear — carry on" report is likely to be met with some skepticism.

Personal Trading

Perhaps ironically, the conceptual gulf between liquid trading funds (such as hedge funds) and real estate funds engenders a lack of awareness of personal trading restrictions among real estate fund managers, making them susceptible to violations of SEC rules. In particular, Rule 204A-1 under the Advisers Act mandates the establishment, maintenance and enforcement of a "code of ethics" that prescribes certain minimum reporting requirements.

Directors, officers and partners of a fund manager, as well as any supervised persons with access to nonpublic information or investment recommendations (in practice this frequently means all staff) should typically be designated as "access persons" in this context. Designation as an access person imposes initial and ongoing reporting obligations for brokerage accounts and other reportable securities in which the individual has "any direct or indirect beneficial ownership," which includes, among others, accounts controlled by immediate family members sharing the same household. Personal trading violations have included situations where not all accounts required to be reported were reported.

In addition, access persons are required to seek pre-clearance (typically from the CCO) before participating in any private placement or initial public offering of securities. Care should be taken to address personal real estate holding companies in this context.

Custody Rule

Fund managers in the real estate sector frequently pursue multiple strategies, and many successful managers operate a diverse platform of closed-ended and open-ended funds alongside separate accounts and deal-by-deal co-investment vehicles. Separate accounts and co-investments continue to be a strong focus for OCIE for a variety of reasons, but can also present a weakness under the SEC's "custody rule" (Rule 206(4)-2 under the Advisers Act). Registered investment advisers are deemed to have custody of client assets whenever they have the authority to withdraw funds from a client account. This type of "constructive custody" should be considered when structuring or reviewing co-investments and separate accounts. When the custody rule does apply, client assets must be held with a bank, broker-dealer or other "qualified custodian" (unless they are "privately offered securities") and there are additional notice, account statement delivery and surprise examination requirements (unless annual financial statement audits are prepared and timely delivered to all investors).

In addition, real estate fund managers may inadvertently receive physical possession of rent checks, municipal tax refunds and dividend payments on behalf of funds that they manage (generally due to the use of a "care of" address for special-purpose entities). Strict compliance with Rule 206(4)-2(d)(2)(i) under the Advisers Act requires fund managers to return such checks to the sender within three business days of receipt — and not forward them to the custodian bank, which may seem counterintuitive. Although the SEC has issued limited no-action relief for certain tax refunds and dividend payments that might otherwise be unrecoverable,[7] there is no analogous guidance for rent checks. From risk alerts to industry conferences, the SEC has repeatedly put fund managers on notice that the custody rule is not to be treated as a technicality, and several enforcement proceedings have been brought in this area.[8] As a result, and also as a matter of operational efficiency, many fund managers are considering requiring their counterparties to make all such payments by ACH or wire transfer.

Other Areas of Focus

As the SEC capitalizes on its recent exam experience with the private equity industry, real estate fund managers should expect scrutiny of operational areas that may appear to overlap with private equity funds, including requirements for enhanced transparency and reporting with respect to transaction fees, accelerated fees, operating partners, group purchasing agreements and cybersecurity. Critically, just because it isn't interesting to your investors doesn't mean it isn't interesting to the SEC.

There is no way to guarantee a successful outcome to any SEC exam, but in light of the current regulatory and examination patterns we have observed, real estate fund managers should preemptively revisit the following issues:

Management fee income: Review calculation methodologies and timing critically in order to ensure that disclosures in offering memoranda and governing documents both match Form ADV and align with current practice. Any deviations from the manager's headline fee structure (such as in connection with co-investments, separate accounts or cornerstone investors) should be disclosed in general terms to all investors on Form ADV.

Transaction-based and other fee income: Review all fees received by the manager (and its staff and affiliates) for conformity with governing documents and adequate disclosure to investors. SEC representatives have publicly expressed an interest in this area, highlighting the "vertically-integrated" nature of certain real estate management models as a source of potential conflicts. Accordingly, particular attention should be given to disclosure of real estate operating fees, including industry-standard leasing, servicing and property management fees. Where practical, OCIE has also strongly supported line-item disclosure of transaction-based fees and expenses when investors receive distributions from the disposal of a property.

Investment-level fees and expenses: Similarly, review all fees and expenses paid by the funds to third parties in connection with the acquisition, holding and disposal of portfolio properties. Although this has not historically been viewed as "best practice" within the industry, OCIE has at times taken the position that investors should be able to inform themselves as to the types (and potential calculation methodologies) of typical investment-level fees and expenses that the fund may incur by virtue of certain types of portfolio investments.

Expense allocation and reimbursement: Ensure that expenses charged to clients are legitimate fund expenses, within both the terms of the governing documents of each fund (which are typically drafted broadly) and the disclosures to investors (Form ADV and offering memoranda). In particular, establish a written policy prescribing the reasonable and consistent allocation of expenses that benefit multiple clients; these vary by firm and by fund, although some commonly shared expenses include umbrella insurance policies, market data analyses and certain infrastructure such as investor portals. Almost as important as the policy itself is documentation supporting the reasonable basis of those allocations in the context of the manager's business. Where clients are subject to different policies (for example, co-investment vehicles frequently do not bear many of the typical fund operational expenses), this should be clearly disclosed in offering memoranda and on Form ADV.

Conclusion

Our experience of recent examinations reflects the SEC's increased interest in the real estate sector, and we expect this pattern to continue for some time. As a newer group of registrants, real estate fund managers tend to be less familiar with OCIE's rigorous standards and face unique challenges when confronted with their first examination. Maintaining accurate records and documenting steps taken in furtherance of the compliance program are vital to this process. A thorough annual review can assist a fund manager in identifying areas of potential weakness, but those findings must be taken seriously. Because you will always know your own business best, this is not a task that should be left exclusively to external consultants. Allocating sufficient resources to the compliance program is the key first step towards successfully implementing those policies and procedures — in practice and not just on paper.

1 Changes to the Investment Advisers Act of 1940 (as amended, the "Advisers Act") contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") eliminated the widely relied-upon "private adviser" exemption effective July 21, 2011, although existing advisers were permitted to continue to rely on the exemption until March 30, 2012 following an extension of the compliance date.

2 See Schulte Roth & Zabel's Oct. 9, 2012 *Client Alert*, "SEC Announces "Presence Exams" For Newly-Registered Investment Advisers." See also OCIE, Letter Announcing Presence Exams (Oct. 9, 2012).

3 See Andrew Bowden, Director, OCIE, Speech at the Private Equity International (PEI), Private Fund Compliance Forum 2014 (May 6, 2014).

4 PEI Alternative Insight, "PERE CFO and COO Compendium" (2015), LPs on the SEC, 17-19.

5 SEC, 2015 Budget Request by Program 50. See also Julie M. Riewe, Remarks to the IA Watch 17th Annual IA Compliance Conference.

6 SEC, Questions Advisers Should Ask While Establishing or Reviewing Their Compliance Programs (May 2006).

7 SEC No-Action Letter, Investment Adviser Association (Sep. 20, 2007).

8 See, e.g., SEC National Exam Program Risk Alert, "Significant Deficiencies Involving Adviser Custody and Safety of Client Assets" (March 4, 2013); and SEC Compliance Outreach Program, National Seminar (Jan. 30, 2014), Slides. ■