



## Your Real Estate Fund and Dodd-Frank

**05.31.2011**

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Think the Dodd-Frank Act does not affect real estate investors? Think again. Most real estate investors form a limited liability company or limited partnership to buy real estate and have several investors put equity into the entity which is used, along with secured debt, to purchase such real estate. Typically, there are one or more active investors who may or may not put in proportionate equity and who manage the investment and several passive investors who just receive distributions in exchange for their contributions either during the life of the project or upon its sale. Because of the Dodd-Frank Act's changes to the Investment Advisor's Act of 1940, any of those active investors and/or managers that (i) put together a group of investors to invest in real estate (referred to here as a "real estate fund") and (ii) through the real estate fund manage assets, without subtracting debt, worth more than \$150,000,000, will probably have to register as investment advisers under proposed regulations.

Currently, any person required to register as an investment adviser because of the Dodd-Frank Act must register by July 21, 2011; however, there have been several news stories in recent weeks reporting that the SEC is going to delay the registration requirement until the first quarter of 2012 because of the delay in issuing final rules. The SEC has done nothing to contradict these stories.

Here are a few of the legal issues associated with registration that the real estate fund managers will want to consider:

- Disclosure Requirements. Each real estate fund manager registering as an investment adviser with the SEC must complete Form ADV, Part I and file that document electronically via the Investment Adviser Registration Depository (IARD) system, administered by FINRA. In addition, each real estate fund manager must provide its investors with Form ADV Part II, which is a two part disclosure document: part A, which includes 18 categories covering information about the fund manager, its portfolios, its management strategy and its policies and procedures, and part B, which covers information about the manager's employees. This would be in addition to and separate from any private placement memorandum or similar documents that the real estate fund manager provides to investors.
- Enhanced Disclosure Requirements for Private Funds Only - Form PF. As part of Dodd-Frank's focus on systemic risk, all SEC-registered fund managers must file Form PF. Form PF is a new 44 page form designed to provide detailed information about the investments of real estate funds (and the investments of other private funds, including hedge funds and liquidity funds) to the Financial Stability Oversight Council, so it can assess systemic risk, and to the SEC, so it can determine examination

priorities.

- Performance Fee Limitations. Real estate fund managers may only receive performance-based fees from "qualified clients" (proposed to be persons investing more than \$1,000,000 in the fund or with a net worth of greater than \$2,000,000 or certain qualified entities, with fund investors, not the fund, treated as the clients for this purpose). Generally, any payment to the real estate fund manager based on the fund's performance is a performance-based fee. So, when a real estate fund is formed, in addition to ensuring that investors qualify as "accredited investors" under Reg D (generally speaking, the \$200,000 in income or \$1,000,000 net worth test), a registered real estate fund manager that is to receive performance-based fees must ensure that its investors are also qualified clients. If not, the carried interest or other performance-based fee will be illegal. The SEC is due to promulgate rules on the definition of "qualified clients" that, it is anticipated, will clarify the application of the "qualified client" rule to real estate funds. Ideally, this will grandfather funds raised before Dodd-Frank was enacted so that managers of grandfathered funds can continue to receive performance-based fees even if the investors were not qualified clients.
- Custody Requirements; Audited Financials. Under the proposed Investment Advisers Act Rules, many real estate fund managers will elect to (i) have a qualified custodian hold the fund's cash and securities and (ii) have audited GAAP financial statements prepared for the fund and provided to the fund's investors annually, to avoid complying with the SEC's more onerous securities custody rules for investment advisers--which may include, among other things, surprise examinations by an accountant, internal control reports by an accountant and the provision of quarterly securities and cash account statements to all fund investors.
- Records Requirements, Compliance. Under the Investment Advisers Act Rules, a real estate fund manager that registers as an investment adviser, or one that is exempt from registration because it manages less than \$150,000,000 in assets, must keep eighteen different categories of business records. If registered, it also must adopt a compliance program, a code of ethics and an insider trading program, and must have employee supervisory procedures in place. The registered real estate fund manager must pre-clear certain employee securities trades, and employees may be restricted from investing in certain IPOs or limited offerings.
- SEC Examination. A real estate fund manager that registers, or one who is exempt from registration because it manages less than \$150,000,000 in assets, will be subject to periodic examination by the SEC.
- Investment Adviser Representatives. Employees of a registered real estate fund manager who interact with investors will probably need to register as investment adviser representatives, and take the Series 65 or other permissible examination.
- Fiduciary Duties. Enhanced, broad fiduciary duties and anti-fraud rules under the Investment Advisers Act apply to real estate fund managers, even those that are exempt from registration because they manage less than \$150,000,000 in assets.
- Other Practical Issues. The cost for real estate fund managers to comply with the Investment Advisers Act registration requirements will be significant. Real estate fund managers should expect significant expenditures on the initial paperwork and preparation required for SEC registration. Thereafter, real estate fund managers can expect continuing compliance costs that include audit requirements, hiring

compliance employees, preparing Form ADV and Form PF filings, and the ongoing implementation of policies and controls that could add significant additional recurring expense.

These issues are based on what has been released by the SEC so far. The SEC's releases are not final at this point, and several rules have yet to be proposed. Regardless, it is clear that real estate fund advisers will be regulated in a way that they have not been before.

*For more information about this article, please contact Charles E. Kemp, 804.420.6929 or , Laurence V. Parker, Jr., 804.420.6467 or , or any member of the Williams Mullen Business & Corporate Practice.*

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