

COMPLIANCE STRATEGIES FOR PRIVATE REAL ESTATE FUND MANAGERS

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MCLE Certification Information

- Most participants should anticipate receiving their certificate of attendance in 3 to 4 weeks following the webcast.
- Virginia Bar members should anticipate receiving their certificate of attendance in 6 weeks following the webcast.
- Questions regarding MCLE information should be directed to Jeanine McKeown (National Training Administrator) at 213-229-7140 or jmckeown@gibsondunn.com.



Agenda

- Regulatory Environment
- Particular Issues Faced by Real Estate Fund Advisers
- SEC Examination Process
- Practical Tips for Preparing for and Managing an SEC Examination



Regulatory Environment

Regulatory Environment

- Recent speech by Mary Jo White (Chair of the SEC) focused on various potential **systemic risks** posed by or that the private fund industry is subject to:
 - Operational Risks
 - Succession or transition for one adviser to another
 - Cybersecurity
 - Stress testing
 - Firm-specific compliance risks
 - Marketing
 - Disclosure of conflicts
 - Fees and Expenses

Regulatory Environment

- In addition, Chair White singled out the work of the Private Funds Unit (“PFU”), noting that the Unit is completing a review of private fund real estate advisers, particularly with respect to the use of related parties to provide ancillary services
- According to Chair White:

“Staff is concerned that disclosure about these arrangements may be non-existent or potentially misleading, particularly with regard to whether or not the related parties charge market rates.”

Regulatory Environment

- Igor Rosenblitz provided some additional insight into the PFU's private real estate fund initiative in an address to the PLI's Hedge Fund Management 2015 program
- According to Rosenblitz:
 - The initiative is “now bearing fruit”
 - “Millions of dollars” in fees have been returned to investors
 - Some managers have done so proactively prior to being examined by the SEC

Regulatory Environment

- Three significant recent SEC enforcement actions involving allocation of fees and expenses
 - Allocation of 100% of broken deal expenses to Funds without taking into consideration co-investors lined up to participate in the failed transaction
 - Acceleration of monitoring fees upon sale of portfolio companies
 - Shifting of monitoring fees away from the manager to an affiliated consulting firm so as to avoid management fee offsets
 - Negotiation of discounted service provider fees for the manager (without making the same discount available to the Funds)

Regulatory Environment

- Observations:
 - Beware of fee or expense allocation practices that appear to have a disproportionate impact on Funds (or other clients)
 - Under the Advisers Act, a breach of fiduciary duty equals securities fraud
 - This gives the SEC broad power to bring enforcement actions against advisers for practices that violate the SEC’s sense of what is “fair” to investors
 - Disclosure is critical, but not a “cure-all”



Particular Issues Faced by Real Estate Fund Advisers

Particular Issues Faced by Real Estate Fund Advisers

- Property management, construction, and leasing fees
 - Adequacy of fee disclosure (particularly if fees are being paid to affiliated service providers)
 - Undertakings that any fees paid to affiliates will be at “market rate”
 - Assessment of comparables
 - Thoroughness of comparison pool
 - LPAC Review and Approvals
 - Adequacy of the information provided
 - Retention of fees by adviser where services are subcontracted out to third party providers

Particular Issues Faced by Real Estate Fund Advisers

- Pass through of certain overhead expenses (e.g., salaries of property management personnel)
 - Adequacy of disclosure
 - Assessment of market rates where affiliated parties used
 - Allocation where property manager is serving multiple properties

Particular Issues Faced by Real Estate Fund Advisers

- Policies and procedures to ensure that investment and co-investment opportunities are allocated across all funds and other clients in a fair and equitable manner
 - Allocations of investment or co-investment opportunities to the firm, or to friends and families of the firm, are subject to heightened regulatory scrutiny
- Adequacy of documentation maintained to record the rationale for allocation decisions
- Adequacy of disclosure and LPAC review

Particular Issues Faced by Real Estate Fund Advisers

- Application of custody rule to Sub-REITS
 - At least one SEC Regional Office has taken the position that Sub-REITs must be treated as separate “clients” under the Custody Rule, due to the existence of third party “accommodation shareholders” in such structures.
 - According to this logic, real estate fund advisers are required to separately comply with the Custody Rule for each Sub-REIT by either:
 - Obtaining audited financial statements for each Sub-REIT; or
 - Complying with the quarterly statement and annual “surprise audit” requirements under the Rule.
 - Unclear how widely or consistently this interpretation is being applied by the SEC

Particular Issues Faced by Real Estate Fund Advisers

- Some General Observations
 - General disclosure about the adviser’s ability to charge a fund for any expenses that benefit the fund is usually considered insufficient.
 - Particularly for expenses that are considered atypical or that are used to reimburse affiliates, the SEC expects explicit disclosure
 - When reviewing market rate determinations for fees paid by vertically integrated real estate firms to affiliated property management companies, the SEC will use third party providers as its benchmark
 - SEC tends to discount arguments that the level and quality of the services provided by third party providers are significantly different from those provided by affiliates
 - Full disclosure and LPAC sign-off are essential

Particular Issues Faced by Real Estate Fund Advisers

- Some General Observations (cont.)
 - The SEC will carefully scrutinize the counterparties and joint venture partners in any property deal acquired or sold by a fund for potential conflicts
 - If the adviser, its principals or affiliates (or even large investors in the fund) have any sort of interest in one of the counterparties or JV partners, the SEC expects that this will be treated as a conflict and addressed accordingly
 - The SEC would carefully scrutinize whether any fees received by the adviser have been properly accounted for under any applicable management fee offsets.
 - The SEC is very suspicious of anything that appears to be an attempt to allocate fees and expenses in such a way as to reduce management fee offsets

Particular Issues Faced by Real Estate Fund Advisers

- Some General Observations (cont.)
 - The SEC will carefully scrutinize even relatively immaterial expenses that are allocated to a fund
 - Travel expenses (especially by private jet) and entertainment expense create bad optics, even when reasonable



SEC Examination Process



SEC Examination Program

- Registrants are targeted for review based on a risk assessment performed by SEC. Factors considered include:
 - Size (AUM)
 - Affiliated relationships
 - Prior examination history

SEC Examination Program

- Typical Exam Process
 - Initial document request
 - On-site inspection
 - Off-site review and analysis
 - Potential Outcomes:
 - No Further Action Letter
 - Deficiency Letter
 - Enforcement Referral



Examination Priorities

- SEC communicates its industry-wide examination and enforcement priorities through:
 - Annual examination priority memorandums
 - SEC Staff speeches

Document Requests

- An SEC Examination typically begins with a lengthy document request
 - Quick turnaround times apply (typically 2 weeks or less)
 - Essential to maintain comprehensive records and to have these materials organized and readily accessible
- The documents typically sought from registrants in recent exams give insight into SEC's current priority areas
- In addition, the specific items included in a document request letter can sometimes provide intelligence about the issues the SEC intends to focus on in a particular exam

Real Estate Fund Inspections

- For each Adviser, provide a schedule of current and former investments held during the Examination Period by each advised fund, including:
 - Investment name
 - Date of original investment
 - Dates of follow-on investments
 - For each follow-on investment, the amount of the investment
 - Name(s) and amount(s) of any co-investor(s)
 - Realization or disposition dates
 - Realized amounts
 - Value of remaining investment/unrealized amount (if any)
 - Investment level gross IRR (if available)
 - Name of Fund that made the investment
 - Seller of the Investment
 - Whether the Investment is also held by an SMA client

Real Estate Fund Inspections (cont.)

- For each Adviser, provide a schedule of current and former investments held during the Examination Period by each advised fund, including:
 - Lending broker
 - Asset Manager
 - Property Manager
 - Whether Property Manager is an affiliate of the Advisers (Y/N)
 - Leasing Agent
 - Whether Leasing Agent is an affiliate of the Advisers (Y/N)
 - Construction Manager
 - Whether the Construction Manager is an affiliate of the Advisers (Y/N)
 - For situations where the fees are shared or services are outsourced, provide the fee split and identify the party with whom they are split



Practical Tips for Preparing for and Managing an SEC Examination

Steps to Take Before Examiners Arrive

- Notify senior management and assemble a cross-functional team
 - Designate a Point Person
 - Experience and judgment are critical
 - Request that employees direct all questions and requests to the Point Person
 - The Point Person's responsibilities should include
 - Review and verify accuracy of information conveyed and documents provided to examiners
 - Maintain detailed record of communications with examiners
 - Seek and provide regular updates from/to the examiners
 - Provide regular updates to internal team
 - Provide ongoing education, guidance, and advice to employees

Steps to Take Before Examiners Arrive

- Inform employees of the exam
 - Provide instructions and guidance
 - Dress and behave professionally
 - Be polite and cordial, but cautious
 - Do not offer meals or entertainment
 - If approached with questions, politely refer examiners to the Point Person
 - Arrive at work on time and expect to stay late if necessary
 - Ensure that workspaces (e.g. desks, printers, conference rooms, etc.) remain clean
 - Ensure that trash cans and recycle bins remain free of sensitive information
 - Lock workstations when away from your desk
 - Keep conversations in common areas to a minimum
 - Stand ready to be called to interview

Steps to Take Before Examiners Arrive

- Carefully review the Document Request List
 - Engage in a dialogue with staff to narrow/clarify certain requests
 - Consider circulation of a document preservation memo
- Collect responsive documents
 - Know where all relevant data resides
 - Paper and electronic
 - Main and branch offices
 - Off-site storage
 - Third-party service providers
 - Privileged documents should be clearly marked
 - After copying/scanning documents, return all documents to original location

Steps to Take Before Examiners Arrive

- Determine whether to request confidential treatment
- Organize all documents requested
 - Keep original creation and edit dates for electronic files
 - Redact as necessary
 - Create privilege log for any documents being withheld or redacted
 - Label folders
 - Provide cover letter with description of documents being produced, the request to which they are responsive, and the bates number range, if applicable
 - Include “N/A” responses

Steps to Take Before Examiners Arrive

- Determine physical location for the examiners' workspace
 - Comfortable room
 - Telephone and internet access
 - “Convenient” location
 - Consider building security procedures
- Prep employees for interviews
- Prepare for opening interview

The Opening Interview

- Should be attended by senior management
 - A gauge of an adviser’s “culture of compliance”
- Deliver an educational presentation
 - Basic information about the business
 - History
 - Ownership and key employees
 - Client and LP base
 - Affiliates
 - Basic information about the compliance program
 - CCO qualifications
 - Compliance resources
 - Material risks and key controls

Employee Interviews

- Expect the SEC to interview a variety of employees
- Tips for interviewees
 - Review relevant policies and procedures in advance of the interview
 - Be prepared for multiple interviewers
 - Some questions will be broad and open-ended
 - Be aware of your body language
 - Do not speculate
 - If you make a mistake, correct yourself
 - Stand ready to provide examples of any reports, schedules, or checklists used to perform duties discussed during the interview
 - All interviews should be treated as sworn testimony

The Exit Interview

- Examiners will convey their findings and overall concerns
- Engage in dialogue with the examiners
 - Demonstrate commitment to the firm's compliance function
- This is an opportunity to mitigate Examination Summary Letter comments
 - Advocate firm's position with respect to each of the preliminary findings
 - Take issues to supervisors and beyond before a deficiency is cited
- This is also an opportunity to clarify any misunderstandings
 - Correct misunderstandings
 - Offer to provide additional information

The Examination Summary Letter

- Responding to the Examination Summary Letter
 - The response should cover each comment in sequence to its presentation in the SEC’s letter
 - The staff usually leads with the most significant comments
 - Detail the steps taken to correct deficiencies
 - Demonstrate that you “get it” and take potential issues seriously
 - Explain how restitution was or will be made if economic harm to clients was found
 - Never say corrective action was taken if it is still in process
 - Simply describe the stage of correction
 - Work especially closely with outside counsel on comments that are threatening or severe
 - Commend the staff on its professionalism
 - Respectfully ask for additional time to respond if needed



Questions/Comments



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C. William Thomas, Jr. is a partner in the Corporate Transactions Department of Gibson, Dunn & Crutcher's Washington, D.C. office. His practice emphasizes the formation and operation of domestic and international private investment funds, including hedge funds, private equity funds, mezzanine funds, real estate funds and funds of funds. Mr. Thomas has broad experience representing fund sponsors, as well as institutional investors and joint venture partners.

Mr. Thomas has been ranked nationally as a leading lawyer for Investment Funds: Hedge Funds in the 2013 guide of *Chambers USA: America's Leading Lawyers for Business*. He is also recognized by the *Best Lawyers in America*® 2015 publication in the area of Administrative and Regulatory Law.

He is the author of "The AIFM Directive: Implications For Non-EU Managers," in *Law360* (August 2010); "Private Investment Funds in Turbulent Times" in *Inside the Minds: Private Equity and Venture Capital Trends in a Turbulent Economy* (2009); and "Structuring Sales of Subsidiaries or Divisions," in *Business Separations Transactions: Spin-Offs, Subsidiary IPOs and Tracking Stock* (2006).

Mr. Thomas is a member of the District of Columbia, New York and Massachusetts bars. He received his law degree from Harvard University in 1998, *magna cum laude*. While at Harvard, he served as Books Editor of the *Harvard Human Rights Journal*. Mr. Thomas received his master of arts degree from the Fletcher School of Law & Diplomacy, Tufts University in 1998 and a bachelor of arts degree from Dartmouth College in 1992, *summa cum laude*.

Mr. Thomas serves as a member of the Board of Directors of the Society for Latin American Justice.



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Marc Fagel is a partner in Gibson, Dunn & Crutcher's San Francisco office and a member of the Firm's Securities Enforcement and White Collar Defense Practice Groups. Mr. Fagel's practice focuses on the representation of public companies and their officers and directors, as well as financial institutions, investment advisers, hedge funds, private equity firms, broker-dealers, accounting firms and others in investigations and examinations conducted by the Securities and Exchange Commission, as well as by the Department of Justice, FINRA, and other regulatory bodies. Mr. Fagel also conducts internal investigations and represents clients in related civil actions.

Prior to joining the Firm, Mr. Fagel spent over 15 years with the SEC's San Francisco Regional Office, most recently serving as Regional Director from 2008 to 2013. In his role as Regional Director, he was responsible for administering the SEC's enforcement and examination programs for Northern California, Washington, Oregon, Alaska, Montana and Idaho, managing a staff of more than 100 lawyers, accountants, and other professionals. Before his appointment as Regional Director, Mr. Fagel served as Associate Regional Director in charge of enforcement.

While at the SEC, Mr. Fagel conducted, supervised and oversaw hundreds of investigations in nearly every major subject area of the SEC's enforcement program, including public company disclosure and reporting; the Foreign Corrupt Practices Act (FCPA); insider trading; and investigations of major financial institutions, investment advisers, hedge funds and broker-dealers. He was at the forefront of the SEC's initiative on stock option backdating and oversaw some of the largest securities fraud cases filed in the Pacific Northwest.

Before joining the SEC, Mr. Fagel spent six years as an associate at a large national law firm, where he specialized in representing technology companies and their officers and directors in securities fraud class action litigation. Mr. Fagel received his undergraduate degree from Princeton University and graduated in 1991 with Honors from the University of Chicago Law School, Order of the Coif.

Mr. Fagel currently serves on the Board of Directors of Jewish Family and Children's Services of San Francisco and the Law Center to Prevent Gun Violence, as well as the Board of Advisors of the SEC Historical Society.



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Greg Merz is of counsel in the Washington DC office of Gibson, Dunn & Crutcher. He currently practices in the Corporate Department, where he focuses on regulatory issues, product development and corporate transactions for investment advisers, private and registered investment funds and other financial services products and institutions. He has extensive experience with the application of federal and state securities laws to all aspects of the asset management industry, including the Investment Advisers Act of 1940, the Investment Company Act of 1940, Securities Act of 1933, the Securities Exchange Act of 1934, Dodd-Frank Wall Street Reform and Consumer Protection Act, Graham-Leach-Bliley, the USA PATRIOT Act, the Bank Secrecy Act and state blue sky laws.

Prior to returning to private practice in 2011, Mr. Merz was employed in a number of in-house positions in the asset management industry. Mr. Merz was a Managing Director & Deputy General Counsel for eight years at Legg Mason, where he focused on counseling the firm's various registered investment advisor affiliates on regulatory matters, product development and government relations. He was also involved in supporting Legg Mason's retail managed financial products (including mutual funds, closed end funds, collective investment trusts, 529 plans and retail separately managed accounts) and in the negotiation and implementation of a number of corporate acquisitions, divestitures and restructurings for the firm.

Before joining Legg Mason, Mr. Merz worked at Fidelity Investments for over nine years. While at Fidelity, he provided legal support to a number of different business functions, including portfolio management operations, investment compliance, various international and special product development initiatives, and mutual fund administration.

From 1985 to 1992, Mr. Merz was an Associate in the New York and London offices of Debevoise & Plimpton, where he was engaged in a general corporate practice with an emphasis on financial services, mergers & acquisitions and international securities law.

Mr. Merz earned his law degree in 1985 from the University of Chicago, where he was on the University of Chicago Law Review. He graduated *magna cum laude* from Middlebury College in 1981 with a Bachelor of Arts degree in Political Science.

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Prior to joining ACA in 2006, Mr. Wilson served as a Securities Compliance Examiner at the SEC's Chicago Regional Office. While at the SEC, Mr. Wilson took part in or led several examinations that were referred to the SEC's Division of Enforcement for further investigation. Mr. Wilson also participated in Risk Targeted Examination Sweeps of advisers to private funds and high-yield municipal bond funds, as well as exams conducted pursuant to Chairman Cox's Senior Initiative. In addition, Mr. Wilson trained new SEC employees on examination techniques and represented the SEC on panels of industry professionals.

Mr. Wilson graduated cum laude from the University of Dayton with a B.S. in Finance.