The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or “the Act”) impacts investment advisers in multiple ways. Some of these ways are quite clear, such as the requirement for hedge fund and private equity fund managers to register with the Securities and Exchange Commission (SEC); others will become clear once regulators begin setting rules to define the Act and the scope of its coverage.

Advisers to certain real estate funds should be aware of potential impacts to their business model. For example, the Act may require some advisers to real estate funds to register with the SEC as investment advisers. Regardless of their obligations concerning registration, advisers to real estate funds are likely to face new record-keeping and reporting obligations. Advisers to real estate funds will also take on very significant new obligations (and a new regulator in the Federal Reserve) if they are deemed “systemically important” by the new Financial Stability Oversight Council (FSOC). Looming as a possibility in the longer term is the imposition of a self-regulatory organization (SRO) for investment advisers. This A Closer Look provides an initial perspective on the impact some of these considerations may have on advisers to real estate funds.
Registration requirement for advisers to real estate funds

Real estate funds invest primarily in private real estate equity, including direct and indirect interests in real property; private real estate debt, including mortgage loans and mezzanine debt; public real estate equity, including securities related to real estate such as real estate investment trust (REIT) securities; and/or public real estate debt instruments such as commercial mortgage backed securities (CMBS) and collateralized mortgage obligations (CMOs). When structuring investments for real estate funds, advisers may consider, among other things, tax efficiencies associated with different types of investments and factors associated with the requirements of applicable investors and related jurisdictions. Such considerations may influence the debt and equity characteristics of the investment as well as the type of legal entities utilized: partnerships, limited liability corporations, real estate investment trusts, and other taxable corporations. Depending on the specific facts and circumstances, the investment may be considered a security for the purposes of the federal securities laws. To the extent a real estate adviser causes a fund to invest in securities (as opposed to directly in real property), the adviser may fall within the definition of an investment adviser under the Investment Advisers Act of 1940 (Advisers Act).

While many real estate investment advisers have been registered with the SEC for years, others have historically relied on the “private adviser exemption” within Section 203(b)(3) of the Advisers Act in order to avoid registration as an investment adviser. The private adviser exemption did not require registration for investment advisers with fewer than 15 clients. Dodd-Frank eliminates the private adviser exemption. Thus, unless another exemption applies, advisers to real estate funds that fall within the definition of “investment adviser” will likely have to register with the SEC.

Other exemptions for which advisers to real estate funds may be eligible include the following new exemptions created under Dodd-Frank:

**Smaller advisers.** Advisers solely to private funds with assets under management of less than $150 million, and other advisers with less than $100 million in assets under management, with certain exceptions, are not subject to registration with the SEC. For advisers in states that will not be subject to state registration and examination, and advisers that would have to register with 15 or more states, the minimum assets under management for SEC registration will be $25 million. While exempt from registration, these advisers may be subject to record-keeping and reporting requirements.

**Foreign private fund advisers.** Foreign private fund advisers are exempt if they do not have a place of business in the United States, have fewer than 15 clients in the United States, and have less than $25 million in assets under management in private funds for US clients and investors.

**Family offices.** Family offices are exempt from registration consistent with the SEC’s current exemptions. The SEC will define the term in a manner consistent with existing exemptive orders.

Given that each real estate fund may be structured differently and may have different investment strategies, advisers to real estate funds should examine their legal structure and consult with counsel to determine whether the registration requirement applies to them or whether they may be eligible for an exemption. If the conclusion is that the adviser must register, the adviser should immediately begin efforts to prepare for registration by the July 2011 deadline. The registration readiness initiative should include: (i) designating a chief compliance officer; (ii) conducting a gap analysis of current compliance policies/procedures and internal controls to determine the areas that need to be remediated; (iii) conducting a risk assessment to determine the adviser’s specific conflicts of interest and risks; and (iv) undergoing a mock SEC exam in order to evaluate the adviser’s preparedness in adequately responding and participating in a real SEC examination. (Please see “Additional considerations for advisers required to register,” below, for examples of additional requirements when transitioning from an unregistered adviser compliance program to a registered adviser compliance program.)
On the other hand, advisers to real estate funds that only invest directly in real property (such as residential buildings, commercial buildings, and land) may be able to avoid registration based on the fact that these types of investments may not come within the definition of “securities” and therefore subject the investment adviser to the Advisers Act. The term “securities” is key: Real property is not a security for purposes of the Advisers Act. Through an analysis of an adviser’s investment strategy and the types of investments made—in this case, directly in real property—an adviser to real estate funds may conclude that registration is not applicable.

Conflicts of interest and SEC focus areas for real estate advisers

Real estate fund advisers that register with the SEC need to pay careful attention to the additional conflicts presented by the types of investments these funds typically make. Conflicts inherent in a real estate fund structure differ from those inherent in other strategies (such as a long/short equity strategy), due in large part to the development of relationships with appraisers, appraisal reviewers, property managers, and others. One example of such conflicts arises in the relationship between the adviser and the appraiser or appraiser reviewer who is assisting in the valuation of the property at issue. While there are standards that should be followed, such parties may be tempted to provide an appraisal that is advantageous to the adviser, in order to secure repeat business. Such an appraisal may not represent an independent and objective determination of the fair value of the property at issue. Advisers registered with the SEC will need to disclose such conflicts and establish controls to limit or mitigate their potential impact.

Examples of additional common SEC areas of focus for advisers to real estate funds include:

- Valuation of the property in the portfolio
- Allocation of real estate investment opportunities among eligible funds
- Co-investments by principals of the adviser with the fund(s)
- Undisclosed ownerships in the subject property by the adviser or its affiliates
- Receipt of material nonpublic information in connection with making an investment in a property
- Joint venture operating partners
- Disclosure of track records and performance

Other requirements

Even investment advisers that are exempt from SEC registration will need to assess whether they will be subject to record-keeping and reporting obligations. For example, Dodd-Frank empowers the SEC to issue rules requiring investment advisers to make and keep documentation concerning:

- The amount and types of assets under management
- Use of leverage
- Counterparty credit risk exposure
- Investment positions
- Valuation policies and practices
- Side arrangements or letters
- Trading practices

In consultation with the FSOC, the SEC may also require that additional information be kept if it determines that keeping such information is necessary and appropriate in the public interest, for the protection of investors or for the assessment of systemic risk. The Act allows for different reporting requirements for different classes of fund advisers, based on type or size of the private fund.

Finally, investment advisers to real estate funds—whether required to register or not—remain subject to the SEC’s anti-fraud rules and thus to the agency’s enforcement authority. In addition, state-regulated advisers will need to be alert to state regulatory requirements, including possible new examination strategies.
Following SEC rule-making, advisers to real estate funds will be required to create and keep records that will be specific to their business as advisers to private funds. The SEC may craft additional record-keeping and filing requirements that would allow it to identify heightened investor protection risks and to monitor for systemic risk. Advisers should review their IT infrastructure to determine whether their systems are adequate to respond to SEC requests and SEC reporting requirements.

Additional considerations for advisers required to register

The transition from unregistered to registered adviser may be quite daunting, requiring compliance with many onerous and time-consuming requirements of the Advisers Act, such as those detailed here.

206(4)-7 “Compliance Rule.” The Compliance Rule requires registered advisers to real estate funds to: (i) designate a chief compliance officer who is responsible for administering the policies and procedures of the adviser; (ii) adopt and implement written policies and procedures; and (iii) no less than annually, conduct a review of the adequacy of those policies and procedures.

Code of ethics. Registered advisers to real estate funds are required to adopt a written code of ethics that sets forth a standard of conduct for its employees.

Monitoring and surveillance procedures. Based on the real estate fund adviser’s implemented policies, procedures, and code of ethics, the adviser should develop surveillance procedures to adequately monitor activity within the firm for violations of law and the adviser’s specific policies.

Books and records. With registration, advisers to real estate funds will be required to maintain and preserve the appropriate books and records of the firm, per Rule 204-2 of the Advisers Act.

Form ADV. Upon registration, advisers to real estate funds must complete and file a Form ADV, which identifies certain aspects of the adviser’s business, including a statement of the adviser’s policies and procedures, any noted conflicts of interest, biographies of key employees, etc. Registered advisers to real estate funds will need to keep their Form ADVs up to date, at least on an annual basis or upon any material changes.

Custody. Newly registered real estate fund advisers must comply with the new Custody Rule, which generally applies to accounts that contain securities over which the investment adviser has custody. The determination of whether a specific real estate investment is considered a security is a facts-and-circumstances analysis about which the adviser and its legal counsel should make a determination. Care should be exercised when applying the audited pooled investment vehicle exemption as well as when considering the applicability of provisions involving account statement delivery, surprise exams, and internal control reports.

Use of marketing materials. While the use of marketing materials may not be new to newly registered advisers to real estate funds, the additional considerations that need to be contemplated prior to distribution of the materials may be. For example, if information on performance is contained in the marketing materials, advisers to real estate funds will need to ensure that they have the appropriate books and records to support those numbers, as required by the books and records Rule 204-2.

Valuation. Valuation is important, especially when illiquid assets are held by advisers to real estate funds. In particular, the methodologies for valuing direct and indirect interests in private real estate debt and equity will become important in determining the value of each of the adviser’s holdings. Additionally, the SEC will be focused on these methodologies during exams.

Affiliated broker-dealers. Certain advisers to real estate funds—for example, those that distribute shares or units in non-traded REITs—may conduct business using an affiliated broker-dealer. However, such advisers must consider the additional conflicts of interest that such relationships entail.

The additional requirements and responsibilities of registered real estate fund advisers should not be taken lightly. Advisers need to staff their compliance departments with adequate resources to be able to appropriately monitor all policies and procedures. In addition to having sufficient resources, advisers will need compliance resources that have relevant prior experience, preferably at other similar firms.
While Dodd-Frank will have significant impact on advisers to real estate funds, many implementation issues are currently unclear and are subject to federal agencies’ rulemaking processes and various statutorily directed studies. PwC will continue to monitor those developments and provide you with updates, which will be available at www.pwcregulatory.com.

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