King & Spalding

Client Alert

Real Estate Practice Group

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SEC Brings Heightened Scrutiny to the Real Estate Fund Industry

The Securities and Exchange Commission (SEC) has expanded its focus on private equity funds to ancillary asset classes, including specifically private equity real estate funds, with its Private Funds Unit ("PFU") undertaking a thematic review of the real estate fund industry. In a recent speech[1], Mr. Marc Wyatt, Acting Director of the Office of Compliance Inspections and Examinations, addressed the areas of concern and focus for the SEC in the private equity arena[2]. In particular, practices concerning fees, expense allocations, valuation and co-investment allocation have all been—and still represent—the areas of most concern for the SEC. In his speech, Mr. Wyatt pointed out that it is incumbent upon managers to "fully and fairly describe "the deal" to investors, including discussing in a meaningful way how expenses will be assessed and fees will be collected".

Areas real estate fund managers should take note of include:

i. Fees charged by property management affiliates—in their examination of real estate funds managers, the SEC has focused on issues surrounding the pricing and substantiation of services provided by vertically integrated owner-operator advisers whose affiliates provide additional real-estate related services such as construction management, property management and leasing services for additional fees. The SEC, having found examples of real estate managers charging back to the real estate funds the costs of their employees who provide asset management services and their in-house attorneys, undertook a closer examination of the disclosure of fees and expenses. While in some instances the PFU found that these ancillary services were not disclosed in the first place, the PFU discovered that a common practice among fund managers is to charge the funds fees at or below market rates for the ancillary services based on broad disclosure surrounding the fact that the fees would be at or below market rate. While the SEC noted that the general nature of the disclosure was in many instances inadequate, they further found that real estate managers were unable to produce back-up documentation to substantiate claims that the fees were indeed at or below market rate.

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ii. Focus on allocation of expenses among funds—the SEC is looking closely at how managers allocate operational expenses, broken deal expenses and formation expenses among funds, including among parallel fund structures and co-investors, where fees are directed away from insiders and preferred investors (*i.e.,* co-investors). The SEC has frowned upon managers where fees have been allocated unevenly to the main co-mingled pooled investment funds, including most recently bringing an enforcement action in the private equity context against KKR[3].

iii. Valuation and performance advertising—as mentioned by Mr. Andrew Bowden in his famous "Sunshine Speech" in May last year[4], advisers should ensure that they are using a valuation methodology that is the same as the one that has been disclosed to investors. Investment advisers should also avoid cherry-picking comparable investments when including information about past performance in offering memoranda and other marketing materials without providing sufficient disclosure to investors.

iv. Failure to disclosure preferential rights—The SEC noted instances where fund investors were not aware that another investor received priority co-investment rights. Allocating co-investment opportunities in a way that is inconsistent with what is disclosed in the offering documents can constitute a material conflict of interest. While the SEC has not prescribed a particular way in which co-investment allocations should be made, it has reiterated the fact that investors need to know what their rights are vis-à-vis other investors. Silence in disclosure documents is not a license for fund managers to allocate valuable co-investment opportunities in any way they desire. Investment advisers should be especially cognizant of ensuring that promises made to investors on an individual basis, whether formally through side letters or more informally through email communication and telephone or other oral communications, are consistent with the disclosures contained in offering memoranda and other marketing materials.

Real estate fund managers should take prophylactic measures to ensure their fee, expense allocation, co-investment allocation methodologies and disclosures pass the litmus test hinted at by Mr. Wyatt in his recent speech. We would be happy to discuss and review what measures should be taken in light of the SEC's continued focus on real estate fund managers.

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This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice. In some jurisdictions, this may be considered "Attorney Advertising."

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[1] "*Private Equity: A Look Back and a Glimpse Ahead*", by Marc Wyatt, Acting Director, Office of Compliance Inspections and Examinations (May 13, 2015).
[2] "*Private Equity: A Look Back and a Glimpse Ahead*". See text of speech here:
http://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html
[3] *In the Matter of Kohlberg Kravis Roberts & Co. L.P.,* SEC Release No. IA- 4131 (June 29, 2015). See our previous Client Alert published on July 16, 2015 for additional details – "SEC Steps Up Scrutiny On Private Fund Fee Allocation Practices".
http://www.kslaw.com/imageserver/KSPublic/library/publication/ca071615b.pdf Even though this case was in the traditional private equity context, it remains relevant to all asset classes including real estate.
[4] *Spreading Sunshine in Private Equity*" by Andrew J. Bowden, Director OCIE at Private Equity International Private Fund Compliance Forum 2014 (May 6, 2014). While in his "Private Equity: A Look Back and a Glimpse Ahead" speech, Mr. Wyatt noted inadequate disclosures relating to valuation and improper valuation methodologies as an area of concern, the specific issues were discussed in greater detail in Bowden's "Spreading Sunshine" speech.