2024 Update: Best-Practice Compliance Policies for Real Estate Fund Managers (Part Two of Two)

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Part One of this article, published in the *PREA Quarterly*, Summer 2024, discussed the reasons real estate fund managers should consider adopting compliance policies even if they are not registered or required to maintain such policies under the Investment Advisers Act of 1940, as amended. Part One also outlined compliance infrastructure under the Advisers Act, including the appointment of a chief compliance officer, adoption of written policies and procedures, and periodic documented review of compliance with such policies and procedures. Part Two describes in more detail the standard compliance policies that real estate fund managers should consider adopting.[1]

All managers should consider each of the following policies and procedures and determine which ones they want to adopt, whether in consultation with attorneys who have experience with registered investment advisers (RIAs)[2] or outside consultants who specialize in preparing compliance manuals. The list below is only a start; a manager's particular real estate sector or business may require additional policies and procedures.[3]

1. Advertising and Marketing. On Dec. 22, 2020, the Securities and Exchange Commission (SEC) adopted a comprehensive set of amendments to Advisers Act Rule 206(4)-1 (marketing rule), which consolidates and in some cases changes past interpretations of its advertising rules intended to protect investors from misleading or deceptive advertising practices by investment advisers. Although the marketing rule applies to only RIAs and their related private (not public) funds, compliance with the rule would help avoid a fund manager's advertisements and similar investor communications from violating Rule 10b-5 of the Securities and Exchange Act of 1934, which applies to all entities (including those not acting as investment advisers). Additionally, the use of advertising by any entities is further curtailed when the entities are engaged in a private offering under the Securities Act of 1933, such as those conducted under the private offering exemptions of Regulation D.[4] Real estate fund managers should consider adopting advertising and marketing policies to mitigate the risks associated with such matters, and the policies should note that misleading advertisements may be found to be fraudulent under the federal securities laws and that otherwise private offerings may be deemed to be public offerings in violation of the Securities Act of 1933. Such policies should (a) detail what constitutes advertising/marketing materials; (b) provide for training of the managers' personnel regarding what is and is not acceptable in such materials; (c) detail the types of records, documentation, and support that must be created and maintained by managers with respect to such matters;[5]

1. On Oct. 21, 2024, the US Securities and Exchange Commission (SEC) issued its Fiscal Year 2025 Examination and Priorities, which reflect the SEC's particular focus on managers of commercial real estate funds and have been taken into account in this article.
2. We note that most rules and regulations cited in this article apply to advisers that are "registered *or required to be registered*" with the SEC. Accordingly, for purposes of this article, "registered investment advisers" may refer to investment advisers who are not registered with the SEC but are required to do so under applicable rules based on the type and amount of assets they manage.
3. For example, a fund manager with a focus on environmental, social, and governance (ESG) issues should consider adopting an ESG policy taking into account the SEC's enforcement actions targeting misleading ESG practices constituting "ESG greenwashing," as well as rules proposed by the SEC in May 2022 that would require enhanced disclosure on ESG practices by RIAs, certain exempt advisers, registered investment companies, and business development companies.
4. For fund managers who choose to rely on Rule 506(c) of Regulation D that permits general solicitation and advertising, the policies and procedures should include reasonable verification steps a fund manager must take to verify an investor's "accredited investor" status to ensure compliance with the requirements of Rule 506(c). Mere representation by an investor of net worth or income will be insufficient.
5. Any marketing and recordkeeping policies should also include restrictions on and retention of any off-channel communications, such as communications via personal electronic devices, applications such as WhatsApp, and social media, which have been a focus of recent SEC examinations and enforcement actions.

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and (d) detail the acceptable and prohibited types of marketing practices and communications related to the manager's private offerings.

2. Investment Process and Allocation Policies, Conflicts of Interest. Although it is well settled that RIAs are fiduciaries of their clients, non-RIAs are also often in a fiduciary position with respect to the funds they manage. All fund managers are expected to exercise their fiduciary duties, including the duty of loyalty (avoiding conflicts of interest) and the duty of care (exercising reasonable care in decisions) throughout all stages of the investment process (except as effectively waived in the governing documents to the extent permitted by law). Such managers must exercise their fiduciary duties in selecting and allocating properties among the funds they manage; performing due diligence thereon; and acquiring, financing, developing, and ultimately disposing of the properties, as well as retaining affiliates to provide services, such as development, design, property management, and other services, to such properties. Real estate fund managers should consider adopting a policy that provides general guidelines for the exercise of fiduciary duties. Such a policy may include, to the extent applicable, (a) guidelines as to what constitutes an investment decision subject to the policy; (b) an outline of the property selection and due diligence process; (c) the designation of the person or people who must be involved in any final decision-making related to the acquisition or disposition of a property; (d) the factors upon which such decisions should be made; (e) guidelines related to opportunity allocation, including a requirement that opportunities will be allocated in a fair and equitable manner in light of each fund's investment criteria, objectives, availability of uncalled capital, and investment disclosures; and (f) guidelines regarding service provider retention.

In addition to an asset allocation policy, real estate fund managers should consider adopting other policies designed to address conflicts of interest that may involve any one or more of the fund managers, their affiliates, and/or the clients or funds managed by the fund managers (e.g., in connection with affiliate transactions and fees). Such a policy should at least provide for disclosure of conflicts of interest, including use of affiliate service providers, affiliate fees and methods of calculation of such fees, adviser-led secondary transactions, and transactions between funds and other managers' affiliates, and the policy should outline the managers' guiding principles for mitigating such conflicts.

3. Valuation and Financial Statements. Valuation of portfolio investments is a key component of all performance tracking and financial reporting required of investment advisers and nonadviser fund managers alike. For managers of illiquid assets, particularly real estate fund managers (whether or not they are subject to the Advisers Act), the valuation of these assets can be challenging. In the 2025 Examination Priorities, the SEC staff specifically noted that for funds investing in illiquid or difficult-to-value assets, such as commercial real estate, the SEC plans a heightened focus on valuation, especially with respect to fee calculation. Although adopting a valuation policy may not remove the need to make judgment calls in all cases, it should provide the framework so that investment assets are valued in a fair, consistent, and accurate manner in line with any disclosure requirements. Such a policy should include statements and codifications related to asset valuation published by applicable authorities (such as the Financial Accounting Standards Board) and provide some detail regarding the frequency and method of portfolio assets' valuation. A valuation policy adopted by a real estate fund manager should define "fair value" and specifically outline the valuation data points to be used, the roles and responsibilities of teams involved in the valuation process (e.g., a valuation committee), and estimates acceptable in the valuation of real estate (e.g., information from real estate brokers and professional appraisers). Valuation policies may also recommend using independent valuation companies, especially in connection with adviser-led secondary restructurings or other circumstances presenting conflicts of interest, or on an annual or a biannual basis, which may lower the risk of regulatory scrutiny and provide more comfort to fund managers in validating their internal process. All such aspects of a valuation policy should also be consistent with the fund's offering documents. A real estate fund manager may want such a policy to include recordkeeping and disclosure requirements related to asset valuations and financial statement reporting.

4. Disaster Recovery Plans. As part of their fiduciary duties to clients, investment advisers are required to take steps to protect their clients' interests in the event of a natural disaster, loss of key personnel, or other similar unforeseen events. In line with such fiduciary duties, it is good business practice for both RIAs and non-RIAs to have policies and procedures designed to prevent business interruptions during or as a result of an unforeseen event. Such a policy should (a) identify likely threats to an entity's business (including natural disasters, power or other outages, chemical leaks, terrorist attacks, theft, and the loss of key personnel); (b) establish processes designed to minimize disruptions caused by such events (many of which are employed before or "just in case" something happens); (c) identify key business functions that will take first priority in being restored after an event; and (d) cite arrangements for off-site backup storage of all electronic data and alternative worksites in the event a primary office is unavailable. These plans proved to be very important during the COVID-19 pandemic, when many fund managers were forced to operate from personal homes or other remote offices.

5. Business Continuity Succession Plan. All managers should adopt a clear procedure as to what will happen if one or more principals or key operating employees becomes unavailable for any period. Procedures should provide steps for the immediate appointment of interim replacements for all affected roles and necessary actions to ensure business continuity and notice to affected individuals (in some cases, including investors). Both procedures should occur as soon as practicable after the absence begins.

6. Privacy and Identity Theft. Over the past two decades, various governmental authorities (including the SEC, the Federal Trade Commission [FTC], and various state governments and agencies) have adopted rules, regulations, and laws designed to protect the privacy of individuals and their personal information and prevent identity theft. Such governmental actions include Regulation S-P and Regulation S-AM adopted by the SEC and the so-called Red Flags Rule adopted by the FTC. On May 16, 2024, the SEC amended current Regulation S-P to require RIAs to assess and mitigate incidents involving unauthorized access to or use of customer information, notify affected individuals, and make and maintain written records documenting compliance. By virtue of sponsoring private funds, real estate fund managers may become subject to these provisions and should consider the adoption of a policy addressing the applicable portions of such privacy and identity theft regulations and laws. Such a policy should include (a) guidelines regarding the protection of confidential information and the circumstances under which nonpublic personal information may be disclosed to third parties (b) details regarding the manager's data management system (c) restrictions on working on sensitive matters in public, and (d) procedures for handling a security breach. Finally, this policy may include provisions requiring that certain privacy and other notices be provided to potential fund investors.

7. Cybersecurity. In February 2022, the SEC issued a significant proposed rule that would mandate cybersecurity policies and procedures for all RIAs and registered public funds.[6] Although not directly addressing private funds or other public companies, the provisions applicable to RIAs would also apply to their management of private funds. The rule would require notification to the SEC within 48 hours of discovering a significant cybersecurity incident. The rule also would require extensive policies and procedures, including a written information security plan and incident response plan, to address and respond to cybersecurity threats. RIAs would be required to increase disclosures and recordkeeping around cybersecurity practices, risks, and incidents. While this rule would not apply to private funds sponsored by nonregistered managers, many states and other regulators have laws requiring cybersecurity protections and notices, and cybersecurity incidents have the potential of creating devastating damages to funds and their managers.

8. Anti–Money Laundering and the New US Corporate Transparency Act. On Aug. 28, 2024, the US Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) issued a final rule that will, upon implementation on Jan. 1, 2026, require

6. As of the date of this article, the proposed cybersecurity rule has not been adopted, although some of the topics were addressed in the May 2024 amendments to Regulation S-P discussed under Section 6 in this article.

most private fund managers to adopt and operate risk-based programs requiring anti–money laundering and countering the financing of terrorism (AML/CFT) measures and report suspicious activity to FinCEN. Fund managers should adopt policies designed to comply with AML/CFT laws and regulations (including the USA PATRIOT Act), as well as regulations of the Office of Foreign Assets Control, including policies with respect to (a) the identification and reporting of suspicious activity to the chief compliance officer and the documentation thereof, (b) the process for screening and verifying the identity of fund investors (particularly including foreign entities and government officials), and (c) the federal resources and watch lists to be utilized in the implementation of the anti–money laundering policy. In addition, the US Corporate Transparency Act (CTA), which went into effect on Jan. 1, 2024, is designed to prevent money laundering and other illegal activities and requires each entity (subject to certain exemptions) to file with FinCEN a beneficial ownership information (BOI) report and update such report upon changes to the BOI.[7] The CTA affects both registered and nonregistered fund advisers, and certain exemptions that may be available to registered fund advisers and their entities are not available to nonregistered ones. Each fund adviser should designate a person responsible for BOI report filings to ensure CTA compliance.

9. Code of Ethics. All RIAs are required to adopt a code of ethics under Rule 204A-1 of the Advisers Act. That rule contains requirements regarding the contents of

7. The deadline for filing BOI reports for entities formed (a) prior to Jan. 1, 2024, is Jan. 1, 2025; (b) in 2024, within 90 days of formation; and (c) on or after Jan. 1, 2025, within 30 days of formation.

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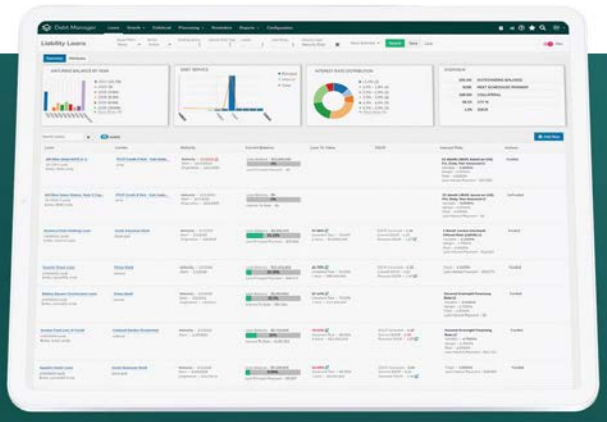

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the mandated code of ethics. Although some mandated provisions may be of little relevance for real estate fund managers (such as personnel's trading reports and trading preapprovals), they are nonetheless required for any real estate fund managers who are RIAs with the SEC. In addition, the adoption of other typical code of ethics provisions, particularly those related to fiduciary standards, gifts and entertainment, and general ethical behavior, are generally good business practices for real estate fund managers of all types, including those not required to register with the SEC.

10. ERISA. Some real estate fund managers may manage funds in which plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) may invest and may even manage funds that themselves constitute "plan assets" under ERISA. Given the implications involved with managing ERISA assets, particularly the additional fiduciary duties imposed by ERISA, real estate fund managers may consider adopting policies related to the management of ERISA accounts. For fund managers who do not already manage funds owning plan assets subject to ERISA, such a policy will often include guidelines designed to avoid the managers' funds becoming plan assets subject to ERISA. For real estate fund managers whose funds are, or are likely to become, subject to ERISA, such policies should include provisions designed to ensure fund managers meet and exercise their fiduciary duties required under ERISA.

11. Use of Artificial Intelligence (AI). Although AI is poised to revolutionize many industries, including asset management, the use of AI imposes many compliance and regulatory challenges, resulting in the need for adoption of applicable compliance policies regarding the use of AI. Many fund managers have already adopted internal policies/guidelines for employees' use of AI designed to protect sensitive business and personal information and prevent violation of privacy and reliance on inaccurate outputs. In addition, the SEC has recently brought a number of enforcement actions targeting "AI washing," i.e., making exaggerated or misleading statements regarding AI capabilities and AI's use. Furthermore, on July 26, 2023, the SEC proposed new sweeping rules that would require any investment adviser using predictive data analytics or other "covered technology" (including AI, algorithmic trading, any digital engagement process, etc.) in connection with engaging or communicating with investors (including exercising investment discretion on behalf of investors) to evaluate such technology for conflicts of interest and eliminate or neutralize those conflicts of interest. The proposed rule is expected to be reproposed in the near future and, as currently proposed, would not apply to nonregistered managers.

Conclusion

Smart investors in funds or separate accounts whose managers need not be registered as investment advisers are insisting that each manager focus on the foregoing issues and adopt the important policies and procedures that are relevant. Fund (and separate account) sponsors will want to adopt and periodically test these policies and procedures and create the necessary descriptions that will be provided investors (in consultation with their lawyers and other advisers) to avoid issues in capital raising and to reduce the risk of enforcement actions. ■

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