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

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This is Part One of a two-part 12-year anniversary update of a predecessor article on the same topic by the authors, which was published in the Fall 2012 issue of the *PREA Quarterly*. This article focuses on the investment adviser compliance policies to be considered by all managers of real estate funds, whether registered under the Investment Advisers Act of 1940, as amended, or not. Part One provides general context of registration requirements under the Advisers Act and discusses the reasons real estate fund managers should consider adopting compliance policies even if they are not registered or required to maintain such policies. Part Two, to be published in the Fall issue, will outline and describe in more detail the standard compliance policies real estate fund managers should consider adopting.

Registration Requirements and Compliance Policies Generally

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act and related rules, absent an exemption, most private fund managers are required to register with the US Securities and Exchange Commission (SEC) or, in some cases, state securities authorities. Under the Advisers Act, a person acts as an investment adviser if the person is providing advice "as to the value of securities or as to the advisability of investing in, purchasing or selling securities" for compensation to others. Accordingly, a manager of a fund owning only real estate and not owning any "securities" is not required to register as an investment adviser. However, even managers who are not required to register as investment advisers under the Advisers Act should consider the implementation of policies and procedures similar to those required of registered investment advisers as a best practice. Further, investors in funds run by unregistered managers may insist that such managers adopt policies and procedures designed to provide protection comparable to that which such investors would receive if the manager were registered with the SEC. Finally, the SEC's increasing scrutiny of real estate fund managers in 2024, both registered and unregistered, further suggests that maintaining and following compliance policies and procedures may assist real estate fund managers in preventing the SEC's enforcement action and penalties.

Compliance Infrastructure Required for Registered Investment Advisers

One primary requirement for registered investment advisers is a formal compliance infrastructure. Rule 206(4)-7 under the Advisers Act ("Advisers Act Compliance Rule") requires that all registered investment advisers:

1. adopt and implement written compliance policies and procedures reasonably designed to prevent and detect violations of the Advisers Act and rules;
2. review at least annually the adequacy of the compliance policies and procedures and the effectiveness of their implementation; and
3. designate a chief compliance officer to administer the compliance policies.

Additionally, new private fund adviser rules adopted by the SEC on August 23, 2023, required that all registered investment advisers document their annual compliance policy reviews in writing; however, the Fifth Circuit Court of Appeals in an opinion issued on June 5, 2024, vacated this (and other related) rulemaking. A person who is acting as an investment adviser but is neither registered as such nor able to take advantage of an exemption from registration is subject to significant

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enforcement provisions, which may include penalties and sanctions (which are beyond the scope of this article).

To comply with the requirements of the Advisers Act Compliance Rule, as soon as a fund manager is required to adopt a compliance program, the manager must assemble an infrastructure for the implementation and operation of the policies and procedures.[1]

Compliance Policy Provisions and CCO

The policies should provide for the appointment of a chief compliance officer (CCO) and provide general details regarding the CCO's duties and powers vis-à-vis the compliance program. The CCO is responsible for the administration of the compliance program. The SEC further stated that an "adviser's chief compliance officer should be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm. Thus, the compliance officer should have a position of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures."[2]

Periodic Testing

Any written compliance program should also include a policy regarding the periodic testing of the compliance program as a whole. As noted, the other specific requirement (in addition to appointing the CCO) under the Advisers Act Compliance Rule is that the adviser must review the adequacy of the compliance policies and the effectiveness of their implementation on at least an annual basis. In practice, such reviews are often conducted by the CCO and the results reported to the governing body (e.g., board of directors) of the investment adviser. The written policies adopted by a fund manager should provide general details regarding the frequency and subject of such reviews, the person(s) responsible for conducting the reviews, and the manner in which the results thereof are reported (and to whom).

Unregistered Fund Advisers

Some real estate fund managers have concluded that no Advisers Act registration is required because their advice to the fund relates only to real estate interests and not securities.[3] Some of these unregistered fund managers, though, have decided to put together compliance policies and designate CCOs for a variety of reasons. First, even though managers may not be subject to the Advisers Act, they may be subject to other laws, some of which require formal policies. For example, nonregistrants may be subject to corporate-level insider trading penalties, Employee Retirement Income Security Act (ERISA) rules, pay-to-play prohibitions, anti–money laundering rules, the US Corporate Transparency Act (CTA), privacy protection laws (including cybersecurity regulations), and foreign corrupt practices laws. All fund managers must always comply with anti-fraud laws and laws requiring managers to act in good faith. In some cases, such applicable laws or rules may require fund managers to adopt policies and/or maintain certain records; in other cases, adoption of procedures and policies may reduce sanctions if a violation occurs.

Second, institutional investors (as a practical matter and as part of their due diligence procedures) generally insist that all their fund managers have appropriate internal compliance policies at some less-exhaustive level, even if a manager is not registered under the Advisers Act. This is particularly true for government plans, large pension plan investors, funds of funds, and large non-US investors. In many instances, such investors have designated specific policies to be adopted by fund managers prior to subscribing to new funds, joint ventures, or separate accounts and even have insisted that real estate fund managers affirmatively

1. As discussed under "Unregistered Fund Advisers," a manager should prepare written compliance policies and procedures (and adopt them), even if not subject to the Advisers Act.
2. "Compliance Programs of Investment Companies and Investment Advisors," SEC, 17 CFR Parts 270 and 275, 2003.
3. The answer to whether a fund manager is acting as an investment adviser with respect to a fund and its assets is beyond the scope of this article and very dependent upon the types of assets held in a real estate fund. If the manager is operating at least in part as an investment adviser to a fund by giving advice regarding any "securities" (as defined) for compensation, particular rules govern whether the manager must register as an investment adviser, whether such registration must be with the SEC, and what SEC reporting may be required (even if SEC registration is not required). As a basic rule, investment advisers with $110 million or more of regulatory assets under management (RAUM) (as defined), even with one client, must register with the SEC unless an exemption is available. There are many wrinkles in connection with calculating RAUM, as well as several exemptions from registration, particularly including an exemption from registration (but not reporting requirements) for investment advisers with less than $150 million RAUM that advise exclusively "private funds" (as defined).

seek registration to the extent that registration would be permitted considering the asset mix and size of the funds under management.

Finally, some managers have implemented compliance procedures for their own internal purposes to augment internal controls and to try to avoid any potential problems, regulatory action, or litigation, particularly in light of the SEC's recent heightened scrutiny of real estate fund managers, especially with respect to valuation issues, fee and expense calculations and allocations, and disclosure (or nondisclosure) of sponsor or affiliate compensation and conflicts of interest. Particularly in the institutional space, the threat of being unsuccessful in fundraising (and adverse publicity) may create financial and business risks far outweighing the costs and burdens of producing, implementing, and administering a compliance program.

Accordingly, the adoption of a compliance program, including appointment of a CCO and annual review of compliance policies, has emerged as a best practice in the real estate fund investment industry.

Guidance from the SEC to Registered Investment Advisers

The Advisers Act Compliance Rule does not specify any particular compliance policies, only that the policies collectively be "reasonably designed to prevent violations of the Advisers Act."[4]

In addition, the SEC Adviser Act Compliance Release gives the following guidance to investment advisers:

> "Each adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks. We expect that an adviser's policies and procedures, at a minimum, should address the following issues to the extent that they are relevant to that adviser:
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> - **Portfolio management processes,** including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions;
> - **Trading practices,** including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregated trades among clients;
> - **Proprietary trading** of the adviser and personal trading activities of supervised persons;
> - **The accuracy of disclosures** made to investors, clients, and regulators, including account statements and advertisements;
> - **Safeguarding of client assets** from conversion or inappropriate use by advisory personnel;
> - The accurate creation of **required records** and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;
> - **Marketing advisory services,** including the use of solicitors;
> - Processes to **value client holdings** and assess fees based on those valuations;
> - Safeguards for the **privacy protection** of client records and information; and
> - **Business continuity plans.**
>
> "Rule 206(4)-7 does not require advisers to consolidate all compliance policies and procedures into a single document. Nor does it require advisers to memorialize every action that must be taken in order to remain in compliance with the Advisers Act. In some cases, it may be enough for the compliance policies and procedures to allocate responsibility within the organization for the timely performance of many obligations, such as the filing or updating of required forms."

Although some potential topics above may not be relevant even to real estate fund managers registered under the Advisers Act,[5] the list of topics is a good

4. Note that unlike other comparable securities law rules requiring compliance policies, the Advisers Act Compliance Rule does not specifically mandate compliance with other securities laws or other laws generally. Various provisions of the Advisers Act and its rules do, however, suggest areas for compliance policies, and where there are no express requirements, the SEC frequently determines that policies should be enacted in furtherance of the investment adviser's general fiduciary duties to its clients.

5. For example, trading practices, including "soft dollar" and "best execution," relate to traditional securities investment advisers who purchase traditional stocks and bonds for their clients and have limited relevance to real estate fund managers who purchase only property interests and, in some cases, nontraded interests in entities holding property or property businesses.


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starting point for developing possible compliance policies and procedures. These should be further enhanced to reflect recent regulations affecting private fund advisers, including the SEC's December 2020 amendments to Rule 206(4)-1 under the Advisers Act (aka the Marketing Rule), the CTA, as well as certain areas of focus of the SEC over the recent years, including calculation and disclosure of affiliate fees and expenses; environmental, social, and governance (ESG) claims; issues relating to the appropriate custody of nontraditional securities (which could range from private mortgage notes to crypto investments); and the use of artificial intelligence (AI) in asset management and related marketing claims and conflicts of interest.

List of Compliance Policies

Part Two of this article will discuss in more detail key compliance policies real estate fund managers should consider adopting, including advertising and marketing, investment process and allocation policies, valuation and financial statements, insider trading, disaster recovery plans, business continuity, cybersecurity, privacy policies and identity theft, anti–money laundering and CTA, code of ethics, ERISA, ESG, and the use of AI. ■

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