REGULATORY UPDATE

Impacts the SEC's Private Funds Rules Will Have On Sponsors Specializing in Real Estate Assets

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The Securities and Exchange Commission's (SEC's) focus on the private funds industry remains acute, with several rulemaking initiatives still pending and slated for adoption in 2024. These topics as they develop will be covered in future Regulatory Updates.

In the meantime, the latter half of 2023 and the start of 2024 have been marked by questions and concerns regarding the implementation and compliance burdens relating to the SEC's Private Fund Rules, which were adopted in Aug. 2023 and will begin taking effect in Sept. 2024.

The Private Fund Rules will result in substantial changes across the private funds industry. But the impacts on sponsors that specialize in real estate assets are unique and give rise to particular (and perhaps unexpected) considerations that real estate industry participants should keep in mind as compliance dates for the Private Fund Rules approach.

The most recent Regulatory Update published in the Fall 2023 issue of the *PREA Quarterly* provided a thorough overview of the Private Fund Rules, including summaries of what have commonly been referred to as the Restrictive Activities Rule, the Preferential Treatment Rule, the Adviser-Led Secondaries Rule, the Quarterly Statement Rule, and the Mandatory Audit Rule.

Rather than recount the details of those helpful summaries, this article addresses the questions and concerns real estate fund sponsors specifically have raised since adoption of the Private Fund Rules.

As with any new rulemaking, there remains uncertainty about how exactly the SEC will interpret, administer, and enforce the Private Fund Rules. This article provides guidance for how the real estate fund industry may consider lingering questions going forward.

How Do the Private Fund Rules Apply to Real Estate Private Equity?

All Private Fund Rules are applicable to all SEC-registered investment advisers (RIAs) that advise "private funds." A subset of the rules (namely, the Preferential Treatment Rule and the Restricted Activities Rule) applies to exempt reporting advisers. The scope of this applicability raises some specific questions for real estate sponsors, including with respect to registration status and the definition of a "private fund."

Registration Status

One gating question that may arise—particularly for new sponsors—is whether a real estate fund sponsor must be registered with the SEC as an RIA. As many sponsors who have been through this analysis know, the relevant question on registration revolves around whether a sponsor is providing investment advice with respect to "securities." There is a long history informing the legal analysis and current market practice in this area, which has resulted in many real estate fund sponsors seeking registration as investment advisers—particularly those raising capital from institutional investors that request (or require) their managers to be registered, those owning real estate through underlying joint ventures, those investing in real estate operating businesses, and those engaged in certain real estate credit strategies.

However, depending on investment strategy, investment structures, and applicable SEC guidance, certain other real estate fund sponsors may be able to determine that they provide investment advice with respect to *real estate* rather than *securities*. In these circumstances, a sponsor may take the position that it does not meet the definition of an "investment adviser" and therefore would not be required to register as an RIA or be subject to the Private Fund Rules at all.

Although de-registering is less feasible for existing RIAs, the substantial new compliance burdens of the Private Fund Rules may incentivize new participants in the industry to be more rigorous in analyzing whether they are subject to registration requirements, and existing real estate private equity managers that are not registered as RIAs should be aware that the Private Fund Rules technically do not apply to their business.

Private Fund Status

Even for existing RIAs and new sponsors that register with the SEC, the scope of applicability to private funds raises unique issues for the real estate fund industry. For purposes of the Private Fund Rules, the SEC's definition of private fund is limited to an investment vehicle that would be an "investment company" but for the exemptions of Section 3(c)(1) (less than 100 beneficial owners) or Section 3(c)(7) (all investors meet the heightened "qualified purchaser" financial sophistication standard) under the Investment Company Act of 1940, which are the typical exemptions for private equity and hedge funds.

However, investment vehicles that are able to rely on the Section 3(c)(5)(C) exemption (a real estate company exemption) or another alternative analysis with respect to the Investment Company Act may conclude that they are not subject to the compliance requirements imposed under the Private Fund Rules with respect to these funds. Many real estate funds potentially have flexibility with respect to their Investment Company Act exclusion analysis, but this determination requires a facts- and circumstances-based analysis with sophisticated legal counsel regarding a fund's actual (or proposed) investments and investment structures.

Similar to the above regarding SEC registration, reliance on an alternative exemption may be more feasible for new investment vehicles relative to existing funds. However, the potential upshot of the ability to rely on an alternative exemption is that compliance with the Private Fund Rules may not be required for certain real estate funds.

Historically, this distinction for RIAs has not been particularly meaningful because the relative compliance burdens applicable to a Section 3(c)(5)(C) entity versus a Section 3(c)(7) fund were, in most respects, not significantly different. However, the substantial new compliance obligations for private funds under the Private Fund Rules (and other pending rulemakings, such as the SEC's proposed Safeguarding Rule, which represents an overhaul to the existing Custody Rule) may incentivize some real estate fund sponsors to consider (or revisit) reliance on alternative exemptions to reduce the impact of these rulemakings on operations, including allocation of personnel resources, related compliance costs, and disruption of established practices around investor negotiations and side letter processes. However, we note that the determination to rely on Section 3(c)(5)(C) has other trade-offs that are important to consider—for example in regard to Form ADV, Form PF reporting, New Marketing Rule obligations, and others—and should be carefully analyzed.

In addition to those legal and disclosure considerations, real estate fund sponsors should also be aware of the influence these Private Fund Rules may have on investor expectations. As institutional and other investors become accustomed to disclosures and reporting pursuant to the Private Fund Rules, some of those investors could attempt to push real estate fund sponsors and their investment vehicles to follow the Private Fund Rules regardless of whether the manager is technically registered as an RIA or able to take the position that its real estate fund is not a private fund as defined in the rules and indeed may negotiate for the same or similar protections to be reflected in the legal documents.

How Do the Private Fund Rules Affect Affiliated Service Providers?

Many real estate fund sponsors begin as property management and development businesses before growing their businesses through managing real estate funds. Other real estate fund sponsors acquire and own affiliated property management and development businesses. In both cases, these real estate fund sponsors present themselves as "vertically integrated platforms" with expertise not only in sourcing attractive real estate investment opportunities but also in providing property-level services to the benefit of their funds and investors.

Sponsors that provide such property-level services themselves or through affiliates should be aware that

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the Private Fund Rules will require detailed and ongoing disclosure relating to the fees and compensation payable for these services. Under the Quarterly Statement Rule, quarterly reporting will require, among other items, disclosure on a fund-level and/or an asset-by-asset basis, with line items setting forth the amount of all fees and compensation payable to the adviser and its affiliates. For instance, a real estate fund that owns an investment in a property and receives both property management services and leasing services from affiliated service providers will need to issue a statement setting forth the amount of property management fees and leasing fees paid for such services with respect to the investment vehicle's ownership of that asset as part of the new standardized quarterly reporting under the Quarterly Statement Rule. The method for how these fees are calculated and cross references to relevant sections of the investment vehicle's legal and offering documents supporting the receipt of these fees also must be included.

These services and fees (and the related terms and conditions) are the product of longstanding market practices in the real estate fund industry and negotiated outcomes with investors. In most cases, the itemized disclosures of these amounts is likely to go beyond the content included in historical reporting (and will now be required quarterly rather than, for example, annually), and it remains to be seen whether this disclosure will result in fee pressure or otherwise influence investor decision-making.

Are Closed-End Real Estate Funds Treated Differently Than Open-End Real Estate Funds?

Quarterly Statement Reporting

Another issue that will affect many industry sponsors is whether to treat certain private real estate funds as liquid or illiquid under the Private Fund Rules. It is not uncommon for a real estate sponsor to have funds with open-end features given the rise in popularity in recent years of evergreen, hybrid, and other similar fund structures that aim to maintain a ready supply of investment capital while also offering investors potential liquidity over time. Sponsors have increasingly turned to open-end structures even for a variety of core-plus and value-added strategies, supplementing the traditional role of this vehicle in this industry for the core-focused open-end diversified core equity funds.

Under the new Private Fund Rules, an illiquid fund is any fund that is not required to redeem interests upon an investor's request and has limited opportunities for an investor to withdraw before the termination of the fund. A liquid fund is any fund that is not an illiquid fund. The determination as to whether a fund is liquid or illiquid can result in differing requirements under the new rules. For example, under the Quarterly Statements Rule, all funds are required to show certain performance information, but the presentation and metrics differ based on whether the fund is liquid or illiquid. Illiquid funds are required to show performance metrics that are customary in the private equity industry, including fund-level gross and net internal rate of return (IRR) and multiple on invested capital (MOIC) and gross IRR and MOIC for the realized and unrealized portions of the portfolio. By contrast, liquid funds must show certain net total return metrics for each of the last ten fiscal years; the average annual net total return for the one-, five- and ten-year fiscal periods; and cumulative net total return for the current fiscal year—more comparable to mutual fund or hedge fund reporting.

As an asset class, private real estate is generally thought of as an illiquid investment, and open-end funds include important features such as the use of redemption queues that reflect that reality. Indeed, in an open-end real estate fund, typically there is not a requirement to sell real estate in order to satisfy the redemption requests of investors, and there are market-accepted protections against such mandated fire sales. This reality has given rise to a debate within the industry as to whether an open-end real estate fund (unlike an open-end hedge fund) should be considered liquid or illiquid, and the answer to that question has a meaningful impact on what performance information must be disclosed to investors. A determination that one fund or another is liquid under the Private Fund Rules could drive unusual results for real estate sponsors and increase burdens on back-office personnel. For example, if a liquid and an illiquid fund have similar investments or invest alongside each another, the reporting information provided to the investors in each fund will be significantly different. Similarly, pitch materials for

private funds typically utilize IRR and MOIC metrics rather than total return regardless of whether the fund is open or closed end. This may result in accounting personnel needing to compute two sets of performance numbers for reporting and marketing purposes.

Preferential Treatment Considerations

Another feature of the Private Fund Rules that can differ based on whether a fund is liquid or illiquid is the prohibition on granting certain rights under the Preferential Treatment Rule. Under the Preferential Treatment Rule, subject to certain limited exceptions, fund sponsors are not permitted to grant any investor in a private fund (or a similar pool of assets) preferential rights with respect to either liquidity (i.e., redemption or withdrawal) or transparency (i.e., information rights relating to a portfolio asset) if the adviser in each case reasonably expects such rights to have a material, negative effect on other investors. The analysis as to whether a given right may have a material, negative effect on other investors is based on the facts and circumstances; however, the SEC noted that this determination should take account of the liquidity of a fund's investments in the case of preferential liquidity rights and the ability of an investor to act upon any information received (i.e., via redemption) in the case of preferential transparency rights. The implication of this is that the analysis as to whether a given right may have a material, negative effect on other investors may be based, in part, on whether the fund is liquid or illiquid, where preferential rights granted in a liquid fund generally have a greater potential to result in a material, negative effect and trigger the prohibitions. To illustrate the complication, consider an open-end fund that is invested side by side with a closed-end fund in various investments. If these funds are "similar pools of assets," then any right granted with respect to closed-end fund investors must also be analyzed vis-à-vis the open-end fund investors, and because of the potential liquidity of the open-end fund, the conclusion regarding material, negative effects may be different in situations in which there is no open-end fund that constitutes a similar pool of assets. Similarly, established side letter terms with a given investor may not carry to an open-end liquid fund and could need to be renegotiated and tailored accordingly.

Given the limited guidance under the Private Fund Rules on the nature of similar pools of assets, sponsors are continuing to wrestle with these issues, and absent clarifying SEC guidance (which is considered by most observers to be unlikely) will have to make judgment calls informed by developing market practice and other risk calculus factors.

How Do the Rules Affect GP-Led Secondaries?

The Private Fund Rules also require RIAs to obtain third-party pricing support in the form of a fairness opinion or valuation opinion from an independent opinion provider, together with a written summary of any material business relationships during the past two years between the opinion provider and the RIA. Given the prevalence of continuation funds and other multi-asset secondary transactions initiated by sponsors in recent years, the secondary market has evolved and matured significantly, and in many asset classes (such as buyout funds), third-party pricing support is already customary under current market practices. That said, the rule imposes a one-size-fits-all requirement, so real estate sponsors engaging in secondary transactions will be required to ensure that the third-party pricing support conforms to the rules.

Conclusion

There are many questions and concerns raised by the Private Fund Rules that remain unaddressed by the SEC and as to which market practice has not yet evolved. Industry participants are well advised to pay close attention to these developments as they work to adopt procedures intended to comply with these new rules. ■

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