Real Estate Fund Documentation and Operations May Be Impacted By SEC Risk Alert

Larry Hass
Paul Hastings LLP

Max Rosenberg
Paul Hastings LLP

Josh Sternoff
Paul Hastings LLP

On June 23, 2020, the US Securities and Exchange Commission (SEC) Office of Compliance Inspections and Examinations issued a Risk Alert, identifying a series of deficiencies it regularly encountered in recent examinations of private fund advisers, including real estate fund managers.

The Risk Alert does not set forth new standards for conduct for real estate fund managers; instead, it puts real estate fund managers on notice of three categories of deficiencies the SEC has regularly identified in its reviews of private fund advisers:

- gaps in client and investor disclosures regarding conflicts of interest
- issues relating to fees and expenses
- issues with policies and procedures regarding the treatment of material nonpublic information

Many of the issues the Risk Alert addresses have been the subject of SEC enforcement actions and other public guidance issued by the SEC since the adoption of the Dodd-Frank Act and should be duly noted by all private fund advisers, including real estate fund managers.

This article focuses on two conflict of interest items highlighted in the Risk Alert that may have a notable impact on real estate fund documentation and operations going forward, particularly in light of the COVID-19 pandemic.

Conflicts of Interest

The Risk Alert calls attention to nine types of conflict of interest issues from recent SEC examinations, including conflicts related to the following:

- multiple clients investing in the same asset
- allocation of investments
- financial relationships between investors or clients and the adviser
- preferential liquidity rights
- private fund adviser interests in recommended investments
- coinvestments
- service providers
- fund restructurings
- cross-transactions

Consistent with prior SEC guidance, the Risk Alert characterizes these issues as tied to a manager's failure to provide sufficient disclosure, not as conflicts that are per se breaches of an investment adviser's duties or violations of SEC rules or regulations.

Two of these conflict of interest issues stand out as likely to affect real estate fund documentation and operations going forward during the COVID-19 pandemic and its immediate aftermath.

Multiple Clients Investing in the Same Asset

The Risk Alert indicates that the SEC has regularly identified inadequate disclosure of conflicts arising from different clients investing at different levels of an underlying asset's capital stack, such as investing one client in an equity position and another client in a debt position related to the same underlying asset. Although many real estate fund managers have historically tried to avoid investing different funds and client accounts in different levels of a property's capital stack, the recent dislocation of the real estate market caused by the COVID-19 pandemic appears to be driving some real estate fund managers to employ more creativity in constructing and reconstructing capital stacks, including using affiliated capital sources at various levels.

For example, real estate debt funds are starting to see increased opportunities to foreclose on the real estate assets that secure their debt investments and take equity ownership of in-process real estate projects. In many of these cases, the real estate debt fund may not have the requisite capital available to complete the real estate project from the equity position. However, real estate fund managers that have the capability to complete the real estate project may be inclined to source additional capital or utilize available capital from existing funds or other client accounts (separate from the original real estate debt fund) in order to fund the capital expenditures required of the equity ownership position to complete the project.

As mentioned, the conflict created by a real estate fund manager investing a new fund or client account in the equity position when an existing fund or client account has been invested in a debt position is not a per se violation of duties or other SEC rules or regulations. In many such cases, real estate fund managers have reasonably determined that investing clients in different parts of the capital stack is the prudent way to maximize value for all investors.

However, because the SEC has focused in the Risk Alert on full and fair disclosure of the conflicts associated with such an arrangement, real estate fund managers need to carefully consider the manner in which a new investment in a new piece of the capital stack is disclosed to existing investors in the property. Advanced disclosure in fund partnership agreements and private placement memoranda is ideal, and real estate fund investors should increasingly expect to see real estate fund documentation address in more detail the potential for conflicts of this nature and the manager's intended approach to handling these conflicts in a manner that seeks to consider the best interest of each client (the original fund investors and the new investors entering the capital stack). For real estate funds operating in the market today without these features in their existing fund documentation, a clear and direct discussion with investors is prudent and increasingly likely based on the Risk Alert.

Allocation of Coinvestments

The Risk Alert also flags deficiencies in the accuracy and specificity of disclosures regarding how coinvestment opportunities that arise alongside an existing fund will be allocated among existing fund investors and third parties.

Coinvestments are increasingly used as both a manager tool for acquiring large assets (and growing assets under management) and an investor tool to add direct exposure to real estate assets alongside commingled fund investments, often on preferable economic terms.

Although there has been considerable focus in the real estate fund industry on developing a "market" approach to real estate fund coinvestment terms (the terms of many real estate fund coinvestments are still the result of bespoke negotiations between investors and managers on a case-by-case basis), the SEC has now focused increased market attention on the manner in which coinvestment opportunities are allocated.

The Risk Alert noted that, in some cases, fund advisers are not following their stated policies or processes for determining how coinvestment opportunities should be identified and allocated, and in other cases, fund advisers are not providing adequate disclosure about coinvestment arrangements with other investors, such as sidecar fund clients or other coinvestment fund clients that are intended to have priority rights to coinvestment opportunities.

In this context, coinvestment allocation seems to include both the determination that a particular investment opportunity gives rise to a coinvestment opportunity and the manner in which the coinvestment opportunity is then offered to investors, other client accounts, and/or third parties.

In many cases, coinvestment opportunities arise when a real estate fund manager determines in its discretion under the fund partnership agreement that an investment opportunity is too large for the fund, given various portfolio construction considerations. In some cases, real estate fund managers are granted more discretion to establish coinvestment opportunities, taking into account other strategic investors and/or client accounts with overlapping strategies.

In light of the Risk Alert, it will be important for real estate fund managers to be clearer with investors as to how the manager will determine when coinvestment opportunities arise, and real estate fund investors may expect more direct discussions with fund managers on this topic when analyzing a real estate fund and its potential to generate coinvestment opportunities.

Once a coinvestment opportunity exists, most real estate fund managers seek to avoid overly complicated or time-consuming processes and procedures for offering a coinvestment opportunity to investors, other client accounts, and/or third parties because there is a live investment opportunity in play (which is almost always time sensitive), and the real estate fund manager needs certainty that capital will be available to close the transaction.

However, in many cases, real estate fund managers will agree to offer coinvestment opportunities to certain subsets of fund investors who are actively interested in coinvestment opportunities, and they employ a variety of methodologies to determine how much of the opportunity is offered to which investors and on what terms. In some cases, real estate fund managers work with investors in advance to form dedicated sidecar funds and other coinvestment funds that are specifically focused on coinvesting alongside other real estate funds, which may or may not have priority when coinvestments arise.

Because the SEC has specifically highlighted the issue in its Risk Alert, real estate fund managers should consider their disclosures around priority coinvestment arrangements with fund investors or other client accounts, as well as the manner in which coinvestment opportunities are allocated generally. ■

Larry Hass and Josh Sternoff are Partners and Max Rosenberg is a Senior Associate in the Corporate Department of Paul Hastings LLP.