Privcap/ Webinar Briefing

Q4 2016

How Real Estate GPs Can Handle Increasing SEC Scrutiny

An excerpt from the Privcap webinar
"A New Paradigm for Reporting Fees and Expenses"

Tom Green
RSM US LLP

Lindsey Simon
Simon Compliance

Sponsored by RSM

How Real Estate GPs Can Handle Increasing SEC Scrutiny

The SEC is turning its attention to the real estate sector, looking at the reporting of investment-level and fund-level fees and expenses. Experts discuss what compliance and operational challenges are facing real estate GPs, what best practices are being adopted in the industry, and how LPs view the fee-reporting issue.

David Snow, Privcap: Why is it that the SEC and increasingly sophisticated institutional investors are so focused on fees and expenses?

Lindsey Simon, Simon Compliance: What's interesting is that disclosure has changed in recent years so that LPAs [limited partner agreements] are now becoming more detailed in terms of what that disclosure is for fees and expenses. And a lot of these documents are supposed to be lived with, for anywhere from seven to 10 years. The SEC, when they started registering private funds—especially real estate and private equity funds—in 2012, was not really understanding the difference in the type of disclosures. And so now that they understand private equity and real estate so well, I think that they're seeing a disconnect between what the documents are showing and then what the operations are and what is actually being charged.

Tom Green, RSM: The one thing that we've seen with these real estate structures is that they've gotten much larger and a lot more complex. So the opportunity for unintentional conflicts of interest to occur through related-party arrangements—whether it's asset-management fees or other fees at the joint venture level—has become heightened.

What evidence is there that the SEC is really taking this seriously or that very influential institutional investors are taking this seriously?

Simon: There have been three big cases [recently] that involve fees and expenses at private equity firms: Apollo, WL Ross, and First Reserve. Just looking at the SEC's enforcement actions or administrative proceedings is also a good place to see where the SEC is heading with this.

Lindsey and Tom, you have private equity and real estate fund clients. Are there any misperceptions among these managers about how they arrive at a sense of compliance and a clean bill of health?

Green: In general, one of the misperceptions is that if a fund is getting audited, that will include certain tests around fees and expenses confirming their accuracy. An audit is comprised of tests and procedures deemed necessary for the purpose of expressing an opinion on such financial statements taken as a whole. It does not include tests or procedures for the purpose of expressing an opinion on individual balances or amounts. Therefore, while there certainly will be audit procedures around fees and expenses as they relate to related parties and/or they are shared or allocated across multiple entities, the audit itself will not confirm that the fees and expenses are totally correct.

Simon: When I ask my clients—mostly my new clients—if they've done any testing to review anywhere from 15 to 20 topics within the expense-allocation bucket, they often tell me that their auditors have signed off because their audit was an unqualified opinion, which, as Tom has just said, is not the same. So performing forensic testing on a regular basis on your expense allocations and your fee calculations is something that auditors love for you to do. But it's not something that they are doing as part of their audit.

Green: The other thing that should not be assumed is, if you've been recording and/or reporting and disclosing fees and expenses the same for many years, that you have no issues. It's really important to have some type of test regimen that is done on some-level of frequency to make sure that fees and expenses conform with the documents that are in place.

Many private equity firms are operating from funds that have documentation that was put together 10 years ago. What challenges does that present because the expectations from the SEC and from investors have changed?

↓ CONTINUES ON NEXT PAGE

Green: We can observe over time how fund documents such as PPMs and operating agreements and other related-party agreements in a fund structure have advanced. The entire fund formation and reporting process has changed. And the parties that are participating are a lot more focused, educated, and accountable. As a result, professionals such as compliance consultants, attorneys, and accountants have been able to elevate the document to be a little bit tighter around fees, expenses, and other conflict-of-interest issues.

> "We can observe over time how fund documents such as PPMs and operating agreements and other related-party agreements in a fund structure have advanced. The entire fund formation and reporting process has changed."
>
> –Tom Green, RSM

Simon: One of the things that some of my PE clients across the country are starting to do are additional supplemental schedules that break down some of the fees, because their documents might be 10 years old. And someone who's a CFO knows which expenses are generally booked as fund expenses. Also having the CFO involved in drafts of new fund-formation documents is important.

Lindsey, can you walk us through what a firm that does not have its ducks in a row might look like by way of fees and expenses?

Simon: You would maybe have vague offering documents. You would not have internal policies and procedure guides as to how you're going to allocate expenses. You wouldn't have a spreadsheet set up as to the different funds and their permissible calculation methodologies under the LPAs. You may or may not be calculating correctly, but then you also wouldn't be disclosing specific items—so, for example, in a financial-statement footnote having a related-party transaction footnote that has dollar amounts, or if you had a co-invest vehicle that received certain fees that you didn't offset.

There is a concept of fairness in allocation of expenses that is expected. What does that mean in practice?

Simon: There are some situations where you might have two funds investing in the same deal. It could be that you have another investment advisor that's investing—especially in real estate.

For sure, and that brings up a whole other topic about real estate firms—private equity firms don't generally have this— having the word "reasonable" and "market rate" or "market comps" interspersed throughout their documents. And that puts an actual obligation on you to find out what the market rates are, especially if you have a vertically integrated firm or if you're doing salary reimbursements.

What are some common themes of firms where a lesson has been learned and where it's clear what the pattern of thinking was that led them down the path to eventually get into trouble with the SEC?

Simon: Traditionally, firms that have been around longer have more of a history of living with documents that are vague. It's important to have buy-in from the top. The principals of your firm should know how important this is. The initiative in California is pretty relevant in terms of the disclosure that's going to be required for California pension funds investing in alternative managers. That's going to change disclosures.

The mindset probably needs to change a little. I think there definitely has been a hesitation to disclose. The industry sort of is limping along to a little bit more disclosure. Hedge funds do a ton more disclosures. So it's just a matter of getting to that level, too.

Green: Especially if you're a newer fund or a startup fund, my advice would be to get in front of it at the very beginning, and surround yourself with good professionals and consultants and fund counsel, because it does become extremely complicated, and there's a lot at risk. There's reputational and personal risk. So it really is wise to make the investment in this compliance and reporting function. ■