

## Corporate Governance for Real Estate Investments

One of the changes that came to the private equity industry after the market crash is the Dodd-Frank provisions, which generally brought fund managers under SEC scrutiny. Andrew Bowden, until recently the head of the enforcement division tasked to look into fund managers, caused an uproar in the private equity industry last year when he disclosed that their first round of examinations had found, “what we believe are violations of law or material weaknesses in controls over 50% of the time.”<sup>1</sup> There were a number of issues, but the takeaway is that the SEC is concerned about fees charged or expense allocations to investors or the fund investments that might not be fully disclosed, particularly in the case of so-called “zombie” funds --- net net, the concern is around misalignment of interests between the fund manager and the investors.

Subsequently Bowden seemed to back off of some of his comments, but it does not appear that the SEC has done so. Bowden’s current successor, Marc Wyatt, has reiterated their concerns in this area with a promise of a commitment of resources (more examinations).<sup>2</sup> The SEC vs. private equity industry issues will sort themselves out over time --- likely in slow motion, but the private equity industry has seemed to take notice and is offering more complete disclosures of fee arrangements. Of course, largely what is driving this is investors themselves have taken notice of the SEC’s comments and are, let’s say, curious about the existing fee arrangements in the deals they are invested in.

I suppose it is easy to predict that investors, particularly large investors in private equity deals, will adjust their due diligence procedures to make sure they are fully aware of the complete fee structure and practices of the firms they do business with. Many have embarked on their own investigation of existing deals. All this at a time where interest in investing in real estate is peaking. Obviously if you are in this industry or have institutional investors, you can expect at least a conversation with them around this issue, if not now at least when you are next raising capital.

With this type of news being fairly broadly disseminated, it is likely that even investors in private deals (non-regulated) may have a heightened sense of concern about their arrangement with the investment sponsor/operator. In any case, whether you are a private equity group or a developer with individual investor/partners, it would be prudent to be prepared for questions around the issues outlined above. A review of fees paid to related parties is in order to verify compliance with controlling agreements (management, development and operating) would be appropriate. Having ready answers to investor questions is a very powerful response.

Most investors would like to think that they are investing in fully regulated investments with layers of oversight and review to assure (as much as is practical) that the investor is getting what they bargained for. Historically, the private equity and direct investment in commercial real estate has been somewhat of an exception. Certainly, there is oversight and reporting, but the levels of oversight for many real estate investors has been light relative to most of the rest of the investment markets (think stocks and bonds). It seems the SEC, certainly on the private equity side, is determined to change this. It is hard to say what will result in terms of bleed over to the private real estate investor side of the equation, but it would be prudent to be prepared.

The information in this newsletter was gleaned from a number of sources. If you have a particular question, or would like a citation to the sources beyond those provided, please contact Zane Dennis at [zane@richeymay.com](mailto:zane@richeymay.com) or 303-721-6131.

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<sup>1</sup> <http://www.sec.gov/news/speech/2014--spch05062014ab.html>

<sup>2</sup> <http://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html>