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We previously wrote about some of the key considerations in forming your first multi-asset real estate fund, including structuring, type of investors to target, and the decision about whether to use a closed-end fund or an open-ended fund. Capital markets and real estate markets have shown strength, creating opportunities for investors to deploy capital as the country continues to open back up. After forming your first real estate fund, there are a number of additional considerations to take into account when forming subsequent funds, particularly if the aggregate regulatory assets under management of the funds exceed $110 million or if additional country jurisdictions will be involved.
We asked Jonathan Needell, President & Chief Investment Officer of Kairos Investment Management, about advice for a new fund manager from his experience in forming numerous real estate funds. “Raising a subsequent fund often increases AUM to a point where a manager is not exempt from registration,” Needell says. “That requires a significant investment in operational infrastructure including investment operations, investor relations, cybersecurity, and compliance.”

GROWTH OF YOUR INVESTOR BASE

For your first fund, you likely included investors with whom you had a pre-existing relationship. When moving from the first fund to your second or third fund, you may have a marketable track record, size or targeted capital raise sufficient to entice institutional investors, registered investment advisor platforms, and, potentially, placement agents. It is important to be conscious of whether or not you are acting in any way that broadly solicits and generally advertises opportunities to invest in your fund. If so, Rule 506(c) under the Securities Act contains requirements that must be followed, such as taking reasonable steps to verify that all purchasers are “accredited investors.” If the more common Rule 506(b) under the Securities Act is followed because there is no solicitation or advertisement, then investors will still generally need to be “accredited investors” but there would not be the logistical hurdle of taking reasonable steps to verify that fact.

“QUALIFIED CLIENTS” OR “QUALIFIED PURCHASERS”

Another area that a follow-on fund manager should be aware of is whether its investors are “qualified clients” or “qualified purchasers.” If the fund manager is registered with the SEC or is located in certain states, it may not be able to charge a performance-based fee (i.e., carried interest or promote) to investors who are not “qualified clients” as defined by the Investment Advisers Act of 1940. A “qualified client” has a technical definition that includes someone with $1 million or more in assets under management with the investment adviser or a person with net worth of $2.1 million or more (excluding their primary residence).

Another consideration is whether it is necessary to confirm that investors are “qualified purchasers” because depending on the number of intended investors and fund portfolio it may be necessary to obtain an exemption from registration under the Investment Company Act of 1940. One of the most common exemptions is for funds where all of the investors are “qualified purchasers.” “Qualified purchasers” include an individual owning $5 million or more in investments and an entity owning at least $25 million in investments. Decisions on type of investor base and potentially number of investors can significantly increase costs, disclosures, and complexity for fund sponsors.

TAX STRUCTURING AND ACCOUNTING

While your first fund may have been primarily domestic, you may find it effective to raise capital outside of the United States. If you are soliciting non-U.S. investors, it will be necessary to have experienced tax advisors to establish a tax structure that is efficient and responsible. There are numerous potential ways to create an appropriate tax structure, including through the use of United States or non-U.S.
feeder funds or blocker entities.

The appropriate structure for your fund will ultimately depend on the identity, preferences, and jurisdiction of your investors. For example, if you have a pension plan investor it will be sensitive to structuring to avoid unrelated business taxable income and if you have a German investor it may require a special purpose entity be created under German law.

One way larger funds create custom vehicles for new investors is by creating parallel funds. Parallel funds are separate funds that invest alongside the main fund but are created to accommodate various tax, regulatory, or other requirements of specific investors. If a complex structure is used, you will need to accurately track and allocate expenses, including employee expenses, among the multiple funds.

INVESTMENT ADVISER ISSUES AND COMPLIANCE

If you have more than $110 million in regulatory assets under management (RAUM), you will be required to register with the SEC as an investment adviser. RAUM is the sum of the market value for all the investments managed by a fund or family of funds that a venture capital firm, brokerage company, individual registered investment advisor, or portfolio manager manages on behalf of its clients.

As an investment adviser, you are a “fiduciary” to your advisory clients (i.e. funds and accounts that you manage). This means that you have a fundamental obligation to act in the best interests of your clients and to provide investment advice in your clients’ best interests. You owe your clients a duty of undivided loyalty and utmost good faith. You should not engage in any activity in conflict with the interest of any client, and you should take steps reasonably necessary to fulfill your obligations. If you do not avoid a conflict of interest that could impact the impartiality of your advice, you must make a full and frank disclosure of the conflict. Furthermore, you must employ reasonable care to avoid misleading clients and you must provide full and fair disclosure of all material facts to your clients and prospective clients.

As a registered investment adviser, you are required to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Investment Advisers Act of 1940, including: portfolio management processes, accurate disclosures, proprietary trading, safeguarding of client assets, safeguards for the privacy protection of client records and information, trading practices, marketing, valuation and fee assessments, and business continuity plans. You must take other steps including preparing and making periodic Form ADV filings, adopting a code of ethics, maintaining required provisions in your advisory contracts with clients, and subjecting yourself to SEC compliance examinations. Registering requires a significant investment in infrastructure including system, compliance, cybersecurity, investor relations, among others.

OUTSIDE FUND ADMINISTRATOR AND INVESTOR RELATIONS

Depending on the size and complexity of your fund (including the cash distribution waterfall or liquidity rights, number of investors, information rights, and other obligations owed to investors), it may be necessary or advisable to engage an
outside fund administrator. A fund administrator can help you with the logistics of your fund and provide services that include partnership accounting, financial reporting, capital call and distribution processing, investor capital account maintenance, treasury services, audit and tax support, and coordinated fulfillment of all investor deliverables. As your investor base grows, you will also likely need an experienced investor relations staff to handle investor reporting, outreach, and relations.

EMPLOYEE PARTICIPATION AND EQUITY INCENTIVES

As you move from your first fund to subsequent, larger funds, you may find it necessary to hire more staff, including acquisition teams to invest the funds raised. Experienced staff often expect the ability to participate in fund investments (without fees or carry) and share in profits, either by sharing in the sponsor’s carried interest or by sharing in certain fee income of the sponsor. The creation of a market equity incentive program will require coordinated corporate, securities, employment, and tax planning.

CONCLUSION

This article has discussed some primary considerations in moving from your first real estate funds to subsequent funds.

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