The Dodd-Frank Act: Impact on Real Estate Investment Entities

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ABSTRACT

On July 21, 2010, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (The Act), which was developed by Congress in response to the financial crisis of 2008. In this paper we briefly discuss the history of U.S. financial regulation, the events leading up to the Dodd-Frank Act, and the intent of the new regulation. We note key events and industry types that contributed to the financial collapse of 2008. We also identify the provisions within the Act that will impact private and publically traded real estate investment entities and analyze the extent of any such impact. The hypothesis of this paper is that certain real estate investment entities are not systemic to the U.S. financial system and if new regulation designed to reform Wall Street and protect consumers is placing a significant burden on these firms without accomplishing the goals of the Act, then real estate investment entities should not be subject to such regulation.

The analytic approach of this paper is to: 1) identify the provisions within the Act that will impact real estate equity entities (i.e., private real estate private funds and REITs), 2) conduct industry interviews to identify the likely short-term magnitude of the impacts due to new regulation and, 3) offer a conclusion as to whether the Act will have a substantial negative effect on the industry.

In conclusion, with respect to these investment entities, we found that the Dodd-Frank Act has improved transparency to investors through increased disclosures. However, the all-encompassing nature of the Act has forced fund managers who were previously exempt from SEC registration to comply with securities regulations regardless of the systemic nature, or lack thereof, of their business practices. While such compliance will not have a substantial negative effect on the industry, we find that the regulation of private real estate funds does not help further the goals of the Dodd-Frank Act.

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CHAPTER 1 – BACKGROUND

1.1 Intent of the Provisions within the Dodd-Frank Act

On July 21, 2010, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (The Act). Congress developed the Act in response to the financial crisis of 2008 with the following purposes:

1. To promote the financial stability of the United States by improving accountability and transparency in the financial system;
2. To end ‘‘too big to fail’’;
3. To protect the American taxpayer by ending bailouts; and
4. To protect consumers from abusive financial services practices ("Dodd-Frank Wall Street Reform and Consumer Protection Act")

In his publication, “Too Big to Save? How to Fix the U.S. Financial System” Robert Pozen, former chairman of the SEC’s Committee to Improve Financial Reporting, provides some insight into the intent of financial regulation. In his opinion, “a regulatory structure for financial institutions should perform the several key functions: reduce the frequency and severity of macromacroeconomic crises, supervise the safety and soundness of financial institutions, and protect investors as well as other consumers of financial services.” (Pozen, 355)

Pozen notes that under previous regulation non-banking entities such as hedge funds were not required to register with any federal agency. Requiring funds over a certain size to register with the SEC would help improve upon the transparency in the financial system. However, Pozen also states that the same registration and reporting requirements should not apply to venture capital or private equity funds since they are not traders or short sellers (Pozen, 366). The reason for increased government regulation is to gain additional information and supervision over financial entities that could pose a systemic risk to the U.S. financial system. Increased regulation will also help the government understand collective risk in the economy with the goal of avoiding large-scale government intervention similar to those that occurred during the 2008 financial crisis.
During the financial crisis of 2008 the government granted funding to a number of financial institutions through Troubled Asset Relief Program (TARP) funding, but Citigroup and Bank of America received additional equity infusions and government aid because they were identified as systemically significant to the U.S. financial system and, therefore, were “too big to fail”. The government has set a goal of ending “too big to fail” because bailout programs such as TARP create a moral hazard in the financial system. Extending implicit guarantees to financial institutions can lead to excessive risk taking. When investors and creditors of these financial institutions know that the government will serve as backstop, they are less likely to monitor the risk levels of these institutions as they are trying to generate higher investment yields.

1.2 History of Events Leading to Dodd-Frank

1.2.1 Brief History of Financial Regulation in the U.S.
As Section II highlights, throughout the history of the United States both federal and state governments have debated how to regulate the U.S. financial system. The result is a fragmented and complex system that has developed in response to a series of systemic shocks that began at the end of the civil war in 1863 with the National Bank Act, which established the Office of the Comptroller of the Currency (OCC) and provided for the issuance of a national currency. As the timelines in Figure 1A and Figure 1B demonstrate, the creation of the OCC was the initial regulatory agency designed to promote an integrated financial system. Moving toward the 21st century, the timeline further demonstrates how a complex and complicated regulatory system evolved with the creation of new regulatory agencies that attempted to respond to historical events in the U.S. economy.

“In the United States today, the system of financial regulation is complex and fragmented. Responsibility to regulate the financial services industry is split between about a dozen federal agencies, hundreds of state agencies, and numerous industry-sponsored self-governing associations. Regulatory jurisdictions often overlap, so that most financial firms report to multiple regulators; but gaps exist in the supervisory structure, so that some firms report to few, and at times, no regulator. The overlapping jumble of standards; laws; and federal, state, and private jurisdictions can confuse even
the most sophisticated student of the system. At times, it can be unclear exactly who regulates whom, what rules apply in which instances, and where to turn for a resolution of these questions. This confusion occasionally inhibits innovation in the financial services industry and investments in some sectors of the economy. At other times, this confusion enables firms and investors to fly under the radar and profit from regulatory arbitrage” (Komai, and Richardson 1).

Source: www.gao.gov

Figure 1A: U.S. Financial Regulation Timeline (1863-1936)
Most of the major reforms to regulation of the U.S. financial system over the last 150 years were triggered by various global or domestic events including wars and the great depression. As Acharya et al. point out in *Regulating Wall Street*, ‘when a large part of the financial sector is funded with fragile, short-term debt and is hit by a common shock to its long-term assets, there can be en masse failures of finance firms and disruption of intermediation to households and corporations’ (Acharya, Cooley, Richardson, and Walter 2). In response to these shocks, Senator Carter Glass and Congressman Henry Steagall tried to address the systemic issues at hand in the Banking Act of 1933 by enacting the Federal Deposit Insurance Corporation (FDIC) in the hopes...
of preventing large-scale withdrawals from retail banks which could render them insolvent. Further, it provided for orderly resolution of troubled banks to avoid failure and, in an effort to protect the FDIC from financial exposure, the Act required retail banks to spin off riskier investment activities into investment bank entities.

The Banking Act of 1933 was geared toward regulating and protecting against market failure by limiting commercial banking activities to commercial lending, and government and general-obligation municipal bond trading. It addressed these issues by taking three important steps:

1. “Identify the market failure
2. Address the market failure through a government intervention
3. Recognize and contain the direct costs of intervention, as well as the indirect costs due to moral hazard arising from the intervention” (Acharya, Cooley, Richardson, and Walter 2)

Although the Banking Act addressed many issues directly related to protecting depositor’s money in the banking system (by limiting risky investment decisions and providing government guarantees), the financial industry began structuring around regulation in the 1970’s by creating a parallel banking system that exploited the loopholes in the regulatory framework of the 1930’s. Acharya et al. describe this regulatory arbitrage as ‘the opportunity and the propensity of the financial sector to adopt organization forms and financial innovations that would circumnavigate the regulatory apparatus designed to contain bank risk taking’ (Acharya, Cooley, Richardson, and Walter 3).

1.2.2 The Need for Revised Regulation Due to Collective Risk

In response to the evolving financial regulation, the banking system morphed into the complex and integrated system dominated by money market funds collecting uninsured short-term deposits, which funded financial firms and investment banks, allowing them to create highly liquid products through derivatives and securitization. The maturities of the secondary products were in stark contrast to the illiquid nature of the underlying loans.

The parallel banking industry grew rapidly and was largely unregulated. According to Acharya et al., these large, ‘complex financial institutions’ ultimately generated a “collective risk” to the
overall financial market that proved to be systemic to the U.S. and global financial system. Collective risk theory focuses on examining an entire system or portfolio as a whole rather than simply summing the effects of each individual entity (Kahn). The S&L crisis of the 1980’s demonstrated that regulations were misguided as they addressed individual risk as opposed to collective risk.

The collective risk of the U.S. financial system continued to grow as it went largely unmonitored or ignored. From 2004 to 2007 the global balance sheet grew twofold according to a 2008 report from the International Monetary Fund. A significant amount of such growth was in the form of subprime mortgages that were originated and ultimately sold as derivatives by non-bank entities that were largely unregulated due to their subsidiary statuses. Further, these products were widely available to the general public and often lacked information regarding the underlying assets and true risk profile. This report also documented that risk levels for individual institutions were low, under Basel I standards, which only fueled the continued growth of the large, complex financial institutions. The result was a global financial meltdown when the housing market crashed in 2007, which led to the financial crisis of 2008.

1.2.3 The Financial Crisis of 2008

One of the major factors that led to the financial crisis of 2008 was the decline of the U.S. housing market and its subsequent impact on the stock and bond markets. Many investors had experienced financial losses due to the dot-com bubble in 2001 and began looking for other places to invest their money. In the early 2000s many investors turned to real estate because they thought it was a safe investment vehicle. Traditional bank lenders began selling their mortgages to special bank entities, Fannie Mae and Freddie Mac, who in turn sold them off to investors in the form of Mortgage Backed Securities (MBS) or bonds (Pozen 3).

In order to produce higher yields for investors, MBS sponsors began focusing on mortgage pools they could assemble that had larger portions of subprime mortgages. Demand for these higher interest rate investments increased and the volume of subprime mortgages rose from $120 billion in 2001 (under 6% of all mortgages originated) to $600 billion in 2006 (over 20% of all mortgages originated) (Pozen 11).
A subprime mortgage is a loan that is given to a homebuyer who does not meet the normal credit standards to obtain a mortgage. Although subprime loans promoted home ownership for lower income families, a subprime loan is a riskier loan product than a conventional home mortgage because sub-prime borrowers are more likely to default. Since MBS pools with a higher percentage of subprime mortgages are riskier due to a greater probability of default, they generate a higher investment yield to compensate investors for the higher default risk associated with the investment (Pozen 10). Former Federal Reserve Governor Edward Gramlich categorized the increase in subprime lending as abusive lending practices due to the hidden fees, prepayment penalties and low teaser rates that were later increased (Pozen 11).

Due to the extremely high demand from investors for high yield MBS, many lenders began offering loans that borrowers could not realistically pay back based on the risky subprime terms. Subprime delinquency rates rose from 11.5% in 2000 to 18.7% on 2008 (HUD Historical Data).
As delinquency rates were increasing from 2006 to 2008, the values of the securities were dramatically decreasing. Many large financial institutions held significant amounts of MBS and as a result of the declining value they incurred significant capital losses.

“The mortgage-backed securities linked to these mortgage loans, spread across nearly all financial institutions, began to lose value. The result was a widespread decline in capital followed by mounting losses and institutional failures” (Sherman, 15). The collective risk was too great as the subprime mortgage crisis proved to be systemic to the overall financial system and in March 2008 the effects were more than obvious when Bear Stearns announced an 88% decrease or a $15 Billion loss in their liquid assets after it became clear that the attempt in 2007 to rescue one of their failing hedge funds with 2.3 billion dollars was unsuccessful. The fund was largely unregulated as it was a subsidiary of a banking entity and not technically within the bounds of regulation. The fund was also more than 90% leveraged. Investors responded to the news by liquidating large portions of their assets. Soon after, Lehman Brothers filed for bankruptcy protection in September 2008 and then in October of 2008 nine large complex banking entities accepted capital injections to stay afloat from the US Treasury. This was arguably the clearest signal that the current regulatory system had failed.
As Figure 4 highlights, the number of nonbank lenders dominated the market and at the peak of sub-prime lending in 2006 only 16% of lending activity was performed by banks, which represented 19% of the total financial volume. The balance was largely unregulated.

![Figure 4: U.S. Mortgage Lending Market 2006](source: www.goa.gov)

As the majority of lending moved away from the traditional bank channels, the role of investment banks increased as they securitized and sold the mortgages to public and private markets. Prior to this shift, government sponsored entities such as Fannie Mae and Freddie Mac were the dominant force in securitization and these loans were traditionally considered to be safer, as they met minimum lending standards and were regulator approved. However, the new vintage of securitized loans from investment banks were far riskier and considered sub-prime but the high yield was attractive to investors and the industry continued to grow rapidly.

“As the volume of subprime lending grew dramatically from around 2003 through 2006, investment firms took over the substantial share of the mortgage securitization market.
As shown in Figure 5, this channel of mortgage funding—known as the private label mortgage-backed securities market—grew rapidly and in 2005 surpassed the combined market share of the GSEs and Ginnie Mae—a government corporation that guarantees mortgage-backed securities. As the volume of subprime loans increased, a rapidly growing share was packaged into private label securities, reaching 75 percent in 2006, according to the Federal Reserve Bank of San Francisco” ("Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdates U.S. Financial Regulatory System" Pages 30-40).

![Figure 5: Growth in Proportion of Private Label Securitization in the Mortgage-Backed Securities Market, in Dollars and Percentage of Dollar Volume (1995-2007)](image)

By 2005, the demand for this type of product made it possible for private label securities to be nearly 55 percent of all mortgage-backed securities issued. This trend, centered on high-risk subprime mortgage backed securities, highlights the regulatory gaps and further demonstrates that a parallel banking industry grew without limitations and oversight. The new mortgage products, which included interest only and various payment option plans, evolved so quickly and responded to market demand forces that the risk profile was largely ignored. “From 2003 through 2005, originations of these types of mortgage products grew threefold, from less than 10
percent of residential mortgage originations to about 30 percent. For many years, lenders had primarily marketed these products to wealthy and financially sophisticated borrowers as financial management tools. However, lenders increasingly marketed alternative mortgage products as affordability products that enabled a wider spectrum of borrowers to purchase homes they might not have been able to afford using a conventional fixed-rate mortgage.” ("Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdates U.S. Financial Regulatory System") Pages 30-40)

When it became apparent that the U.S. was on the verge of a financial collapse due to the series of events detailed above, the US government responded by injecting capital into failing institutions through a series of special lending facilities aimed at stabilizing the economy in the short run by providing liquidity to the market place. From 2007 to 2008 the government intervened in a variety of ways and through multiple avenues. ‘Taken together, the Federal Reserve’s actions through its special lending facilities have resulted in a massive expansion of its balance sheet, increasing its total assets from $900 billion to $2.1 trillion’ (Sherman- Alphabet soup explained: page 1) in one year. **Figure 6** depicts this dramatic balance sheet growth.

![Figure 6: Total Assets of the Federal Reserve (2007-2009)](source: www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm)
From 2007-2009, the government intervention occurred through 10 different special lending facilities aimed at different aspects of failing institutions. Most notably, the government provided loans to deposit institutions allowing them to maintain liquidity through the Term Auction Facility. Further, the ‘Fed attempted to calm financial markets with two facilities designed for short-term borrowing at investment banks, as well as a special purpose vehicle to facilitate the takeover of Bear Stearns by JP Morgan Chase.’ (Sherman Alphabet 1). As economic uncertainty continued to escalate, the ‘Federal Reserve agreed to purchase debt from the government-sponsored entities, Fannie Mae and Freddie Mac, and provided an emergency credit line to the failing insurance company American International Group’ (Sherman Alphabet 1). As noted above, it wasn’t until the bankruptcy filing by Lehman Brothers in September 2008, that the Federal Reserve significantly expanded eligibility to many investment banks to use the special lending facilities, which provided a safety net for failing institutions throughout the United States. The regulatory framework in place at this time was dated and ill-suited for an evolving financial industry that grew uncontrollably and was largely unregulated in the years leading up to the collapse.

In the next chapter we will focus on the regulatory response to the financial crisis of 2008 through the Dodd-Frank Act. We will focus our analysis by making a distinction between debt and equity investment entities and examining the impact of new regulation on real estate equity investment entities, an industry that is not apparently connected to the events leading up to the failure of the system.
CHAPTER 2 – PROVISIONS THAT IMPACT REAL ESTATE INVESTMENT ENTITIES

2.1 Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection was enacted to restore accountability to the U.S. financial system, protect American tax payers by ending bailouts of financial institutions and too big to fail, and protect consumers from abusive financial services practice. There are several provisions of the act that will have an impact on the real estate industry. This paper focuses in on how the Act will impact real estate equity investment entities, specifically REITs and private real estate funds.

For the purposes of this paper, we have categorized real estate investment into two major categories: real estate debt investments and real estate equity investments. Each of these two categories includes both private and public investments, shown in Figure 7 below.

According to Emerging Trends in Real Estate 2012, the total value of real estate capital investment was approximately $3.9 trillion as of 2011-second quarter. Of that total, approximately $2.78 trillion was debt capital and $1.15 trillion was equity capital.
We have chosen to make a distinction between real estate debt investments and real estate equity investments because although it is apparent that debt investment vehicles, such as mortgage-backed securities, can have a significant impact on the U.S. financial system (as discussed in the previous section), it is not clear that equity investment vehicles can have the same impact.
Are real estate equity investment entities being unjustly regulated? Is subjecting these companies to government regulation fulfilling the goals of the Dodd-Frank Act? Are the burdens imposed on real estate equity investment entities significant enough to warrant a change in regulation? If equity investment entities, such as public equity REITs and private real estate funds, are not systemic to the U.S. financial system, should they be subject to the regulation established in the Dodd-Frank Act? These are some of the questions we explore.

2.2 Title I: Newly Established Agencies

The most substantial reform of the Act was the creation of the Financial Stability Oversight Council (FSOC), the Office of Financial Research (The Office), and the Bureau of Consumer Financial Protection. Prior to the Act, the responsibility for financial regulation was dispersed amongst different government entities in a highly fragmented regulatory system as shown in Figure 8A. These newly established government entities were created to regulate the systematic risk of the U.S. financial system and to fill regulatory gaps and oversight failures that existed in the previous structure as shown in Figure 8B.
Source: Pozen, Robert. *Too Big to Save? How to Fix the U.S. Financial System.*

**Figure 8A:** U.S. Financial Regulatory System Prior to Dodd-Frank

**Figure 8B:** U.S. Financial Regulatory System After Dodd-Frank
2.2.1 Financial Stability Oversight Council (FSOC)

The FSOC was created to serve as a systematic risk regulator and respond to the concerns about the bailout of financial institutions that are “too big to fail”. The main purpose of the FSOC is

(A) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;

(B) to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and

(C) to respond to emerging threats to the stability of the United States financial system. (Dodd-Frank Act § 112)

The Council will accomplish these goals by performing the following duties.

(A) collect information from member agencies, other Federal and State financial regulatory agencies, the Federal Insurance Office and, if necessary to assess risks to the United States financial system, direct the Office of Financial Research to collect information from bank holding companies and nonbank financial companies;

(B) provide direction to, and request data and analyses from, the Office of Financial Research to support the work of the Council;

(C) monitor the financial services marketplace in order to identify potential threats to the financial stability of the United States;

(D) to monitor domestic and international financial regulatory proposals and developments, including insurance and accounting issues, and to advise Congress and make recommendations in such areas that will enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets;

(E) facilitate information sharing and coordination among the member agencies and other Federal and State agencies regarding domestic financial services
policy development, rulemaking, examinations, reporting requirements, and enforcement actions;
(F) recommend to the member agencies general supervisory priorities and principles reflecting the outcome of discussions among the member agencies;
(G) identify gaps in regulation that could pose risks to the financial stability of the United States;
(H) require supervision by the Board of Governors for nonbank financial companies that may pose risks to the financial stability of the United States in the event of their material financial distress or failure, or because of their activities pursuant to section 113;
(I) make recommendations to the Board of Governors concerning the establishment of heightened prudential standards for risk-based capital, leverage, liquidity, contingent capital, resolution plans and credit exposure reports, concentration limits, enhanced public disclosures, and overall risk management for nonbank financial companies and large, interconnected bank holding companies supervised by the Board of Governors;
(J) identify systemically important financial market utilities and payment, clearing, and settlement activities (as that term is defined in title VIII);
(K) make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among bank holding companies, nonbank financial companies, and United States financial markets;
(L) review and, as appropriate, may submit comments to the Commission and any standard-setting body with respect to an existing or proposed accounting principle, standard, or procedure;
(M) provide a forum for—
   (i) discussion and analysis of emerging market developments and financial regulatory issues; and
   (ii) resolution of jurisdictional disputes among the members of the Council; and
(N) annually report to and testify before Congress on—

(i) the activities of the Council;

(ii) significant financial market and regulatory developments, including insurance and accounting regulations and standards, along with an assessment of those developments on the stability of the financial system;

(iii) potential emerging threats to the financial stability of the United States;

(iv) all determinations made under section 113 or title VIII, and the basis for such determinations;

(v) all recommendations made under section 119 and the result of such recommendations; and

(vi) recommendations—

(I) to enhance the integrity, efficiency, competitiveness, and stability of United States financial markets;

(II) to promote market discipline; and

(III) to maintain investor confidence. (Dodd-Frank Act § 112)

The Secretary of Treasury chairs the Council and its voting members consist of the heads of the Treasury, Federal Reserve, OCC, SEC, CFTC, FDIC, FHFA, NCUA, and the Bureau of Consumer Financial Protection, as well as an insurance expert appointed by the President and confirmed by the Senate. The non-voting members include the director of the Office of Financial Research, the director of the Federal Insurance Office, a state insurance commissioner, a state banking supervisor, and a state securities commissioner.
2.2.2 Office of Financial Research

The Office of Financial Research (The Office) is housed within the Department of Treasury and headed by a Director, who is to be appointed by the President. It was created to support the FSOC in its mission to identify systemic risks within the U.S. financial market. The Office will collect financial data on behalf of the FSOC; standardize the types and formats of data to be reported and collected; perform research on the U.S. financial system; and make information available to all government financial agencies. The Office may require reports from any financial company if the FSOC determines that the financial market in which the company participates or the company itself poses a threat to the financial stability of the United States. It will use this data to develop and maintain reporting systems for risks to the U.S. financial system and report on changes in system-wide risk levels and patterns to the FSOC and Congress. (Dodd-Frank Act § 153, 154)

2.2.3 Bureau of Consumer Financial Protection

The Bureau of Consumer Financial Protection (the Bureau) is established in the Federal Reserve System as an independent bureau. It regulates the offering and provision of consumer financial products or services under the Federal consumer financial laws. The Bureau will insure that markets for consumer financial products and services are fair, transparent, and competitive. It is also the Bureau’s responsibility to coordinate with the Commission, the Commodity Futures
The primary functions of the Bureau are—

(1) conducting financial education programs;
(2) collecting, investigating, and responding to consumer complaints;
(3) collecting, researching, monitoring, and publishing information relevant to the functioning of markets for consumer financial products and services to identify risks to consumers and the proper functioning of such markets;
(4) subject to sections 1024 through 1026, supervising covered persons for compliance with Federal consumer financial law, and taking appropriate enforcement action to address violations of Federal consumer financial law;
(5) issuing rules, orders, and guidance implementing Federal consumer financial law; and
(6) performing such support activities as may be necessary or useful to facilitate the other functions of the Bureau. (Dodd-Frank Act § 1021)

2.2.4 Potential Impact on Real Estate Investment Entities

So what does this mean for real estate equity investment companies such as REITs and private real estate funds? The purpose of these new government entities is to help promote stability within the U.S. financial system by researching and regulating companies that pose a systemic risk. This could lead to increased oversight on investment practices for real estate companies, but we hypothesize that the existence of these entities will not have a significant impact on real estate equity investment companies.

The FSOC, after a 2/3-majority vote and allowed appeals process by the designated company, has the ability to designate any non-bank financial company as a Systemically Significant Nonbank Financial Company. This designation requires the company to be regulated by the Federal Reserve Bank, which will subject them to more stringent capital, leverage, and liquidity requirements. Aside from larger companies that have real estate
investment divisions, such as BlackRock and Goldman Sachs, we hypothesize that most real
estate equity investment companies are not large enough to be given this designation. We
will explore the impacts of new government agencies in greater detail in Section 4.

2.3 Title IV: Investment Adviser Exemption

2.3.1 Investment Adviser Act of 1940 and the repeal of Section 203(b)(3)
Real estate funds rely on an exemption from the definition of an ‘investment company’ through
sections 3a, 3(c)(1), 3(c)(5), or 3(c)(7) of the Investment Company Act of 1940, which are
defined later on in this chapter. Since these real estate funds are not required to register with the
SEC as ‘investment companies’, the question becomes whether they are required to register with
the SEC as ‘investment advisers’.

Title IV of the Dodd-Frank Act contains many changes to the Investment Advisers Act of 1940
and significantly modifies the thresholds for state and federal registration as well as who
qualifies as an Investment Adviser. The definition of an Investment Adviser in Section 202 of the
Act “means any person who, for compensation, engages in the business of advising others, either
directly or through publications or writings, as to the value of securities or as to the advisability
of investing in, purchasing, or selling securities, or who, for compensation and as part of a
regular business, issues or promulgates analyses or reports concerning securities;” subject to
certain carve outs including those advisers who do not ‘advise’ about securities. However, in
most cases, investment advisers and fund managers of real estate funds have interpreted the term
‘securities’ to include many types of real interest investing. The Act defines Security as,

“any note, stock, treasury stock, security future, bond, debenture, evidence of
indebtedness, certificate of interest or participation in any profit-sharing
agreement, collateral-trust certificate, preorganization certificate or subscription,
transferable share, investment contract, voting-trust certificate, certificate of
deposit for a security, fractional undivided interest in oil, gas, or other mineral
rights, any put, call, straddle, option, or privilege on any security (including a
certificate of deposit) or on any group or index of securities (including any
interest therein or based on the value thereof), or any put, call, straddle, option,
or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ‘security’, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guaranty of, or warrant or right to subscribe to or purchase any of the foregoing.”

One claim that we will discuss in greater detail in Chapter 3 is that real estate funds such as Westbrook have taken the position that they do not invest in securities and therefore do not need to register as an investment adviser with the SEC. However, this is not the position that the majority of real estate funds have taken since they typically invest in partnership and LLC interests, joint ventures, and commercial mortgage loans which all meet the legal definition of a security. There are now 363 registered advisers that manage real estate funds as of June 2012. (www.REAlert.com)

The legal definition of a security has a broad meaning that captures almost any type of ownership position in an investment entity, including interests in profit sharing agreements, transferable shares, or investment contracts. Most fund managers invest in one of these entities, whether it’s through profit sharing in operating companies or joint venture agreements. As Muller and Chertok point out,

“Many types of real estate investments have a securities aspect to them. Types of real estate investments that could be deemed securities include passive entity investments, mortgage-backed securities, asset-backed securities, mortgage participation interests, industrial development bonds, certain types of notes, fractional undivided interests in real estate by which a promoter or nominee assumes the responsibility of physical management of property and distribution of profits to co-owners, certain types of condominiums and real estate development, and certain types of leases and investment contracts. The ultimate determination of whether a real estate investment is a security involves complex, fact-specific legal considerations. Counsel should be consulted when making such a determination.”(Muller, and Chertok)
Further, the Supreme Court issued a ruling on the definition of a security as it relates to interests in real property in the case of the Securities and Exchange Commission vs. W.J. Howey Co., et al., decided that a ‘certificate of interest or participation in any profit sharing agreement,’ specifically with respect to real estate, is in fact a security. (Securities and Exchange Commission v. W. J. Howey Co., 328 U.S. 293 (1946)).

Prior to Dodd-Frank, many of these fund managers, acting as investment advisers investing in ‘securities,’ had long relied on an exemption provided in Section 203(b)(3). This exemption, typically referred to as the “fewer than 15 clients” exemption, allowed fund managers and investment advisers to avoid registration with the SEC or state by relying on the fact that each fund they managed or advised was technically one client and thus typically never exceeded the Act’s limitation of managing or advising 15 clients in one 12 month period. “The SEC generally permitted investment advisers to count as a single “client” any fund they advise, but the SEC did not require such funds to count the individual investors at separate clients”(Muller, Baris and Chertok pg 1). Therefore, as a result, very few fund managers were required to register as investment advisers and avoided compliance and disclosure obligations under the Investment Adviser Act of 1940. The actual language from the Section 203(b)(3) of the Investment Adviser Act of 1940 is contained in Appendix A. As we will point out in later sections, most, if not all, investment advisers who previously relied on Section 203(b)(3) will not meet any of the new exemptions unless they claim that their real estate fund contains no securities.

The Dodd-Frank Act amends Section 203(b)(3) of Investment Advisers Act of 1940 by striking the exemption entirely and replacing it with new unrelated exemption, and has a significant impact on many funds that once relied on the old exemption. In this section we will explore Title IV and what these regulatory changes mean to real estate equity fund managers who are now deemed to be investment advisers. We will also discuss the new thresholds for registering with the state regulators or the SEC. This information will be summarized at the end of this section with visual flow charts and tables.
2.3.2 Private Fund Exemption

As noted above, one of the most significant amendments to the Investment Advisers Act of 1940 was the deletion of Section 302(b)(3) which provided an exemption from registration for many midsized investment advisers. While Dodd-Frank did in fact repeal this exemption, the Act does provide for additional exemptions through the Investment Company Act of 1940 and, most notably, has established an exemption to Investment Companies who advise Private Funds with less than $150 million in assets under management. According to a ruling filed by the Security and Exchange Commission entitled Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, “The primary purpose of Congress in repealing section 203(b)(3) was to require advisers to “private funds” to register under the Investment Advisers Act. Private funds include hedge funds, private equity funds and other types of pooled investment vehicles that are excluded from the definition of “investment company” under the Investment Company Act of 1940, by reason of section 3(c)(1) or 3(c)(7) of such Act.” A fund manager who does not publically offer securities and has 100 owners or less of those securities, can claim an exemption from being an investment company under Section 3(c)(1) of the Investment Company Act of 1940. Similarly, a fund not publically offering securities but has more than 100 owners of those securities, must limit those securities to qualified purchasers under Section 3(c)(7) to avoid being an investment company.

Fund managers claiming an exemption from the definition of an investment company need to have qualifying private funds of less than $150 million of assets under managements. The term “private fund” is defined in Section 202(a)(29) of the Investment Advisers Act as: “an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), but for section 3(c)(1) or 3(c)(7) of that Act.” Accordingly, the exemption is afforded to all qualifying private funds under Section 3 of the Investment Company Act, including 3(c)(5)(c), which many real estate funds rely on. “As a result, advisers are permitted to advise a broader category and a greater number of funds and still rely on this exemption: however, advisers must treat each “qualifying private fund” as a “private fund” for other purposes of the Advisers Act (including for purposes of calculation the $150 million threshold).” (MoFo, Investment Adviser Registration for Private Equity Fund Managers)
As we will point out in Chapter 3, there is ambiguity surrounding the interpretations of the SEC filing exemptions and the filing requirements of form PF with respect to real estate funds. “Real estate funds relying on the exemption provided in Section 3(c)(5) of the ICA are not required to file Form PF (although many real estate funds, because of the nature and structure of their investments, rely on the exemptions provided under Section 3(c)(1) or (7) and therefore may be required to file). (http://www.andrewskurth.com/pressroom-publications-888.html) Form PF will be discussed in further detail later in the section. The specific language in Section 3 of the Investment Company Act affording the private adviser exemption to investment advisers below the $150 million threshold as described above is contained in Appendix B.

It is also important to note that the calculation of the $150 million dollar private fund qualification will be calculated on an annual basis in accordance with the revised definition of AUM in Dodd-Frank, which will be discussed in the following section. If an adviser is deemed to have more than $150 million at the end of a reporting period, they will lose their exemption and be required to file with the SEC unless another exemption applies. However, if the fund AUM fluctuates during the course of the year and at times exceeds the $150 million threshold but does not exceed it at the end of the reporting period, they will remain exempt. As we will discuss in chapter 3, the $150 million exemption to private funds does not apply to many real estate funds because the threshold, on a gross basis, is very low.

2.4.3 The New AUM Thresholds for SEC registration beyond Exemptions
The private fund exemption is the only likely exemption that investment advisers or fund managers for real estate funds might be eligible for. However, as stated above, the exemption is limited to gross funds of $150 million or less, which is a low threshold. Therefore, if a real estate fund does not qualify for the private fund exemption, a real estate fund acting as an investment adviser will have two choices to determine if registration is necessary. The first option is to quantify the adviser’s assets under management in form ADV and then determine what thresholds for registration they fall under. Second, and clearly the more aggressive, approach is to take the position that the fund manager is not investing in or issuing securities. We will first
explore the new dollar threshold requirements and then briefly discuss the second option before evaluating the actual registration process.

The SEC has made changes to the assets under management threshold for registration with the SEC. In general, the SEC has increased the thresholds that trigger federal registration from $25 million to $110 million of Assets Under Management in Section 410 of Dodd-Frank, barring possible exemptions as discussed above. This move will increase the number of Investment Advisers who will have to register at the state level as the change effectively creates three new categories of advisers: Small advisers with less than $25M of AUM, Mid-Sized Advisers with AUM between $25-110M and Large Advisers with AUM in excess of $110M. On the surface, the AUM threshold revisions in Dodd-Frank appear to reduce the number of advisers required to register, however this is not the case as significantly more advisers will be required to register at the state level and the calculation of AUM has been redefined and the previous exemption under Section 203(b)(3) has been revoked.

Prior to Dodd-Frank, Mid-sized Advisers typically registered with the SEC or relied on one of the available exemptions. However, after Dodd-Frank, these Mid-sized Advisers are precluded from registering with the SEC and now must register with the state where they conduct their business. This shift in regulatory policy, when combined with the repeal of the fewer than 15 client exemption, will significantly impact the number of Advisers who will register at the state level. The SEC expects that nearly 4,100 SEC registered Advisers will withdraw registration from the SEC and register at the state level due to their AUM. However, in a ruling issued in October 2010, the SEC expected that there would be 11,658 registered investment advisers by 2011 which is a significantly more than there were in 2007.

Not only did Dodd-Frank revise thresholds for registration of Advisers, they redefined the way an adviser calculates their AUM. Once a fund manager determines that they are an Adviser under the Investment Adviser Act of 1940, they need to calculate their AUM using guidelines contained in form ADV. Item 5.F in part one of Form ADV provides specific guidance on how to calculate the regulatory assets under management (RAUM) for each Adviser of Private Funds to determine which category of registration they must comply with. The specific language can be
found in Appendix C. One of the most important aspects of the new guidelines is that advisers needs to calculate the AUM on a gross basis which includes any outstanding indebtedness and other accrued but unpaid liabilities including fees and expenses. This will significantly impact the reported size of a fund, which in turn will require more advisers to register at the state and/or federal level. Further, with respect to private funds, an adviser needs to:

- include the value of any private fund over which it exercises “continuous and regular supervisory or management services,” including the value of non-securities assets held by the fund (although a sub-adviser to a private fund will include in its RAUM only that portion of the fund’s portfolio for which it provides sub-advisory services);
- include the value of any uncalled capital commitments made to the fund; and
- use the market value or, if the market value is unavailable, a fair value methodology, to value private fund assets, but is not required to determine fair value in accordance with U.S. generally accepted accounting principles (GAAP), and could, for example, utilize a fair value methodology set forth in a fund’s governing documents.

(http://www.andrewskurth.com/pressroom-publications-888.html)

When taken together, the above information requires a fund manager to specifically look to the Investment Adviser Act of 1940, the Investment Company Act of 1940 and form ADV to determine the extent that financial regulation will impact them, if at all. Once a determination is made that the investment adviser will register with the SEC, they need to comply with Form ADV and Form PF which is discussed below. Alternatively, as we will highlight in later chapters, a real estate fund manager, regardless of size, can take the position that their fund is not investing in ‘securities’ as defined by the SEC and avoid registration all together.

The following flow chart summarizes the above analysis specifically regarding registration with the SEC of investment advisers included in our topic. It is not applicable for all investment advisers.
2.3.4 Registration with SEC - what it really means for fund managers

Provision 404 of Title IV of the Dodd-Frank Act entitled, *Collection of Systemic Risk Data; Reports; Examinations; Disclosures* amends many of the reporting requirements for both registered investment advisers and exempt investment advisers in the Investment Adviser Act of 1940. Specifically, these provisions make two significant changes to existing reporting requirements. First, form ADV is significantly modified to include more information. Secondly, a new form PF for “investment advisers registered with the SEC that advise one or more private funds and have at least $150 million in private fund assets under management” has been added to the required filings (“Reporting by Investment Advisers to Private Funds and Certain

2.3.4.a Form ADV

In 2010, the SEC issued a ruling on adopting and implementing the changes to the existing form ADV. The ruling, entitled Amendments to Form ADV, contains justification and responses to the various feedback provided by industry commenters in response to the Dodd-Frank Act. The introduction of the ruling states:

*Investment advisers provide a wide range of advisory services and play an important role in helping individuals and institutions make significant financial decisions. From individuals and families seeking to plan for retirement or save for college to large institutions managing billions of dollars, clients seek the services of investment advisers to help them evaluate their investment needs, plan for their future, develop and implement investment strategies, and cope with the ever-growing complexities of the financial markets. Today, the more than 11,000 advisers registered with us manage more than $38 trillion for more than 14 million clients.*

The above introduction sets the stage for the tone of the document as the SEC paints a clear picture of why they feel that the amendments are justified as well as to reaffirm the stated objective of Dodd-Frank. It should be noted that the numbers are expected to grow under the new guidelines and registration thresholds according to the ruling. Unlike the new form PF, all investment advisers must fill out form ADV to the extent required even if an adviser is exempt under the Investment Adviser Act.

The clear intent of for ADV is to provide investors with the necessary information to allow them to make an informed decision about whom they chose as an investment adviser. The form requires advisers to disclose potential conflicts based on reporting disciplinary history, financial industry affiliations and compensation methods. Advisers must do this through answering a series of questions relating to their organizational structure in part I and by crafting a narrative or ‘brochure’ in part II which will be publically available on the SEC website. The narrative is
required to ‘describe the adviser’s business, conflicts of interest, disciplinary history, and other
important information that would help clients make and informed decision about whether to hire
or retain that adviser’ ("Amendments to Form ADV, 17 CFR Parts 275 and 279", page 5). Prior
to requiring a written narrative, advisers answer a series of check-the-box questions. According
to the SEC, the general consensus among industry professionals was that the old format did not
provide for clear and meaningful descriptions of their investment practices. Generally speaking,
this is an essential component to making an informed decision.

In order to provide a framework of what needs to be included in the brochure, which will be
publically available, the SEC has issued 19 items or disclosures that need to be included in the
narrative. These items are, adapted from the ruling, are:

1. **Cover Page**: name of firm, business address, website, etc.
2. **Material Changes**: information that has changed since the last brochure must be
   identified
3. **Table of Contents**
4. **Advisory Business**: adviser must include information regarding clients’ assets under
   management and the type of advisory services offered, special or otherwise
5. **Fees and Compensation**: adviser must include a fee schedule for their services and
   disclose if the fees are negotiable. Advisers must also disclose if fees are billed separately
   or deducted from client accounts and if there are additional fees paid as brokerage or
   custody
6. **Performance-Based Fees and Side-By-Side Management**: disclosure of performance
   based fees and the fee structure associated with other accounts managed by the
   adviser.
7. **Types of Clients**: disclose the types of clients that an adviser has and what, if any is their
   minimum account size
8. **Methods of Analysis, Investment Strategies and Risk of Loss**: advisers must disclose
   this information and describe material risks for each significant investment strategy
9. **Disciplinary Information**: requires advisers to disclose any material facts about legal
   disciplinary event that is material to a clients evaluation of the adviser and their past
   experience
10. **Other Financial Industry Activities and Affiliations**: requires advisers to describe material relationships they have with related financial industry participants and if there are any conflicts.

11. **Code of Ethics, Participation or Interest in Client Transactions and Personal Trading**: brief description of their code of ethics which will be made available upon request.

12. **Brokerage Practices**: requires advisers to describe how they select brokers for client transactions as well as supporting their compensation packages.

13. **Review of Account**: disclosure of who reviews clients accounts and how often.

14. **Client Referrals and Other Compensation**: brochure must include disclosure about arrangements between advisers and other persons who are not clients and economic benefits between them for adviser’s services to clients.

15. **Custody**: required to state that clients will receive account statements and information directly from custodians who maintain those assets.

16. **Investment Discretion**: adviser must disclose discretionary authority over clients assets and possible limitations that clients might exercise on that authority.

17. **Voting Client Securities**: requires advisers to disclose their proxy voting procedures.

18. **Financial Information**: adviser must disclose their balance sheet showing assets and liabilities if there is a financial condition that is likely to impair their ability to perform their contractual obligations.

19. **Index**

("Amendments to Form ADV, 17 CFR Parts 275 and 279")

In the past most, if not all, of this information has been made available to investors. However, never before has it been filed publically with the SEC on such a large scale. Prior to Dodd-Frank, most fund managers relied on the exemption 203(b)(3) and only provided investors with the information that they requested. As is the case of most real estate funds, defined in form ADV as “any private fund that is not a hedge fund, that does not provide investors with redemption rights in the ordinary course and that invests primarily in real estate and real estate related assets”, investors are typically sophisticated investors who conduct their own thorough level of due diligence on the fund manager. We will discuss the investor/manager relationship in more detail.
in the next chapter as well as costs associated with the new filing requirements; however, it is important to understand that sophisticated investors often required this information from the manager prior to making an investment in a fund.

2.3.4.b Form PF

Form PF is perhaps one of the most burdensome filing requirements added to the SEC’s list. “The new SEC rule requires investment advisers registered with the SEC that advise one or more private funds and have at least $150 million in private fund assets under management to file form PF with the SEC.” While form ADV is a public document intended to provide transparency to investors through disclosures of reporting, conflicts, etc., form PF is considered to a tool to carry out the mission of the Financial Stability Oversight Council by monitoring and evaluating confidential information of private funds to ‘promote the financial stability of the United States’ in accordance with the goals of Dodd-Frank. The SEC expects that the information collected in form PF to be a very important part of the council’s systemic risk monitoring as form PF includes information relating to fund performance, leverage and riskiness of a fund’s financial activities to name a few.

The definition of a real estate fund for form PF is consistent with the meaning for form ADV and, therefore, we are only concerned with the requirements for such funds. As such, a real estate fund, strictly speaking, should only be required to file part 1a and 1b of form PF. However, as we will mention in our analysis section, the industry is unsure how to handle real estate funds that could possibly fit the definition of a hedge fund due to their ability in fund documents to use leverage.

As stated in the SEC’s ruling entitled Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisers on Form PF, ‘section 1a requires information regarding the adviser’s identity and assets under management, section 1b requires information regarding the size, leverage and performance of all private funds subject to the reporting requirements.’ The form is filed on an annual basis at the end of the year for real estate funds. Section 1a is requires information similar to a lot of the information in form ADV and mimics census type questions. Section 1b is more cumbersome, and is specific to fund operations and performance. According to the SEC, Section 1b…
“requires reporting of each private fund’s gross and net assets and the aggregate notional value of its derivative positions. It also requires basic information about the fund’s borrowing, including a breakdown showing whether the creditor is based in the United States and whether it is a financial institution. Advisers must also report the percentage of the fund’s equity held by the five largest equity holders...the form, also require(s) the value of the fund’s investments in other private funds and of the parallel managed accounts manages alongside the fund.”

In addition to this information, each adviser must report on the performance of each fund two ways. First, investment performance must be calculated on a gross basis. Second, it must be calculated net of management fees, incentive fees and allocations. Further, part 1b contains information about investor profiles, which the SEC claims will allow them to further their mission of protecting investors.

When analyzing the questions and information contained in form PF, it is hard to digest what this will actually mean to real estate funds. Further, many commenters have publically expressed their concerns to the SEC which range from hard to determine metrics to simply being inapplicable to mid-sized funds. Many commentators argued that the thresholds for filing form PF should be increased above $150 million. They argued that only Large Private Fund Advisers, in excess of 1.5 Billion hedge funds, should be required to file form PF as they are the advisers with systemic risk information. The SEC publically responded in their ruling that ‘although thresholds set at a higher amount could still yield information regarding much or a majority of the private fund industry’s assets under management, such thresholds would potentially impede FSOC’s ability to obtain a representative picture of the private fund industry.’ Accordingly, the SEC expects that 4,270 SEC registered advisers will manage private funds. Of those, 700 are expected to fall below the $150 million threshold exempting them from filing any part of form PF. Additionally, the SEC expects that of the remaining 3,570 advisers, 3,070 will bear the burden of filing the potentially non-systemic information. The remaining 500 advisers will be considered large private fund advisers and will be required to file all parts of form PF.
Figure 11: Form ADV and PF Flow Chart
2.4 Section 619: The Volcker Rule

Section 619 of the Dodd-Frank Act, also known as the Volcker Rule, is a provision that prohibits banking entities from 1) engaging in proprietary trading, and 2) from sponsoring or investing in hedge funds and private equity funds (with limited exceptions). In this section we will focus on the latter restriction because the proprietary trading restriction is not likely to have a significant impact on the real estate industry.

2.4.1 Entities Covered Under the Volcker Rule

The Volcker rule specifically states a banking entity shall not “acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.” (12 U.S.C. § 1851(a)(1)(B)). A banking entity is “any company that controls an insured depository institution, including a bank holding company or a savings and loan holding company; any foreign bank that operates a branch or an agency in the United States; and any company that controls such a foreign bank.” (Impact of the Volcker Rule, PREA Quarterly, Fall 2010) This ruling also applies to subsidiaries and affiliations of companies that fall under the definition of a banking entity. Therefore, an affiliate of a banking entity is also subject to the Volcker Rule even if it does not control a depository institution.

This provision could have an impact on real estate investment entities because a real estate investment manager that is a subsidiary of a banking entity will also be subject to the restrictions imposed by the Volcker Rule. That manager, who is under the umbrella of a banking entity, will not be allowed to invest in private real estate funds. This will also impact private real estate fund managers who are not regulated by the Volcker Rule because it will limit their ability to raise capital from institutional investors who are restricted from investing in such funds by the Volcker Rule.

2.4.2 Definition of Hedge Fund and Private Equity Fund

A hedge fund or private equity fund is defined in Section 202(a)(29) of the Investment Advisers Act of 1940 as any financial company “that would be an investment company,” as defined in the Investment Company Act of 1940 but is exempt per Section 3(c)(1) (funds with fewer than 100
beneficial owners) or Section 3(c)(7) (funds owned exclusively by qualified purchasers) of the ICA.

According to William Stern of the national law firm, Goodwin Procter LLP, many real estate funds avoid falling under the definition of an investment company using exemptions other than Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. Most real estate funds restrict their investment in securities to use the exemption under the Section 3(a) of the Investment Company Act or restrict their investment to direct interests in real property to use the exemption under Section 3(c)(5) of the Investment Company Act. (Stern 12) Firms using exemptions under Section 3(a) or Section 3(c)(5) do not fall within the regulatory definition of a hedge fund or a private equity fund.

2.4.3 Exceptions to the Volcker Rule

There are two major exceptions to the Volcker Rule. The first is the fiduciary funds exception, which permits a banking entity to engage in “organizing and offering” a hedge fund or private equity if the fund is offered only to customers of the banking entity’s trust, fiduciary, or investment advisory services. This means that a banking entity can have control over the management of the fund if it maintains the required relationship with its prospective investors. However, the banking entity cannot guarantee, assume, or insure the performance of the fund in any way. The fund also cannot share the same name as the banking entity or have any variation of it.

In an attempt to clarify the broad language regarding the requirements for a prospective investor to be considered a customer of the banking entity’s trust, fiduciary, or investment advisory services, the Financial Stability Oversight Council released the following clarification to the fiduciary funds exception in their January 2011 study of the Volcker Rule.

Explicitly, a banking entity is permitted to organize and offer a hedge fund or private equity fund if:

- The banking entity provides bona fide trust, fiduciary, or investment advisory services as part of its business;
• The fund is organized and offered only in connection with such services and only to customers of such services;
• The banking entity does not acquire or retain an equity interest, partnership interest, or other ownership interest in the funds except for a de minimis investment;
• The banking entity does not guarantee or otherwise assume or insure the obligations or performance of the fund;
• The banking entity does not share the same name, or variation of the same name, with the fund;
• No director or employee of the banking entity has an ownership interest in the fund unless he or she is directly engaged in providing services to the fund; and certain other conditions are met ("Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds")

The second major exception to the Volcker Rule is the permitted de minimus investment in a hedge fund or private equity fund. For the purposes of establishing the fund and providing sufficient initial equity to attract investors, a banking entity is allowed to make or retain an investment in a hedge fund or private equity fund. However, the banking entity must dilute its share to no more than 3% of the fund’s total ownership interest within one year of the fund’s establishment. It is also a requirement that the investment made in the fund must be immaterial to the banking entity. Therefore, the fund investment cannot be more than 3% of the banking entity’s tier 1 capital.

The January 2011 FSOC report also clarifies that the Volcker Rule “does not prohibit a banking entity from offering prime brokerage services to an independent hedge fund or private equity fund. …A banking entity may offer prime brokerage services to a hedge fund or private equity fund in which a hedge fund or private equity fund managed, sponsored or advised by the banking entity has taken an interest subject to certain limitations.” These limitations include an “arm’s length” stipulation that requires a banking entity to act as if it were a member bank and the fund were an affiliate thereof.
2.4.4 Intent of the Volcker Rule

In a January 2011 study of the Volcker Rule mandated by the Dodd-Frank Act, the Financial Stability Oversight Council stated that the purpose of restricting banking entities from making investments in or sponsoring hedge funds or private equity is as follows.

1. Ensure that banking entities do not invest in or sponsor such funds as a way to circumvent the Volcker Rule’s restrictions on proprietary trading;
2. Confine the private fund activities of banking entities to customer-related services; and
3. Eliminate incentives and opportunities for banking entities to bail out funds that they sponsor, advise, or where they have a significant investment. ("Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds")

The FSOC study also indicated that the reason for concern over bank entity sponsorship of hedge funds and private equity funds is that it may be a potential source of risk and liquidity stress under certain circumstances. A banking entity may have a strong incentive to provide additional capital to a failing fund in an attempt to mitigate the reputational risk associated with the failure of a sponsored fund. It is also more difficult to properly value and manage the risk to banking entities when their investments are complicated with the sponsorship of hedge funds and private equity funds.
2.5 Title VII: Wall Street Transparency and Accountability

Section 721 of The Dodd-Frank Act amends the definition of a commodity pool in section 1a of the Commodity Exchange Act to now include the use of a swap. The Commodity Exchange Act now defines a commodity pool as:

The term “commodity pool” means any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including any—

(i) commodity for future delivery, security futures product, or swap;

As currently written, this could have a significant impact on many real estate advisers for both public and private companies. This modification in Dodd-Frank will require registered companies that utilize swaps to adhere to another set of regulatory oversight and reporting to the Commodity Futures Trading Commission (CFTC) in addition to the SEC requirements. “The Act creates parallel regulatory regimes for the CFTC and SEC and divides jurisdiction between the two regulators based on whether a ‘swap’ or a ‘security-based swap’ is involved. The CFTC will have jurisdiction over ‘swaps’ and certain swap market participants, and the SEC will have jurisdiction over ‘security-based swaps’ and certain security-based swap market participants.”(MoFo: The Dodd-Frank Act: Cheat Sheet, page 11). For a more inclusive definition of a swap, refer to Appendix D. Prior to Dodd-Frank, the definition of a commodity pool did not include swaps and, therefore, investment advisers who utilized swaps to hedge against interest rate risks were not subject to the CFTC. Many real estate companies, both private funds and real estate investment trusts, enter into swap agreements to protect against interest rate increases over time if they have floating rate loans. The industry relies on these products to reduce their exposure rather than increase it.

Many industry groups are asking for clarification on this issue and are waiting on a final ruling from the CFTC and many professionals believe that the intent of the modification to the commodity pool definition does not include the type of swap utilization that REIT’s and other real estate funds employ. The main argument here is that these fund managers are not trading swaps to generate profits. Instead, they are using swaps to protect the performance of the underlying assets by hedging against interest rate volatility. To qualify as a REIT and maintain
its tax-exempt status, a company must satisfy certain operational income limits. At least 75% of a REIT’s gross income must be from direct real estate related income and 95% of the REIT’s income must be from real estate related income or dividends and interest from non-real estate sources. Therefore, if a company is generating more than 5% of its income through swap investment they would forfeit their REIT status.

As we will discuss in Chapter 3, as currently written, the industry is interpreting Title VII in a variety of ways and many are concluding that their use of swap agreements to mitigate interest rate risks make them subject to the additional regulatory requirements.
2.5 Title IX: Investor Protections and Improvements to the Regulation of Securities

By now, it should be apparent that the Dodd-Frank Act contains many provisions and amendments to various regulatory regimes that have broad sweeping consequences to investment entities that own and invest in real estate. While real estate is not specifically identified in the provisions, certain real estate industries are being affected as the above sections have highlighted.

To further demonstrate the Act’s broad encompassing language, Title IX of Dodd-Frank contains a sweeping overhaul to how public companies disclose and disseminate information to their investors and the SEC. Our study will focus on how Title IX contains enhancements to existing regulation that will impact the SEC reporting and disclosure requirements of public Real Estate Investment Trusts (REITs). We will touch on the most significant changes to financial transparency contained in the Act, which include ‘compensation proxy disclosures’, and ‘shareholder say on pay’. It is important to note that these regulatory changes are modifying existing regulations imposed on all public companies and that the changes can be viewed as enhancements geared towards furthering the stated goals of Dodd-Frank. Therefore, this analysis is more of a summary of how governance is ‘shifted’ to shareholders, in contrast to previously discussed, more burdensome, changes to private real estate funds that were otherwise exempt from reporting prior to the Act.

The two most significant enhancements to SEC regulation of public companies to improve investor protections and increase disclosures to investors are:

1. Compensation Proxy Disclosures
2. Shareholder Say on Pay

Compensation Proxy Disclosure: The Act requires public companies to disclose significantly more information to investors via proxy statements. One additional disclosure required is that companies need to identify compensation paid to executives. The proxy needs to show the relationship between compensation and performance of the company through the use of a visual chart or graph. In addition to tracking this correlation the proxy must also identify the median of
total pay for all of the employees of the company on annual basis (not including CEO pay) and the total pay for the chief executive office of the company. The company is also required to identify the ratio between these two statistics. The clear intent of this change is to provide investors with clear numbers on how employees of the company are compensated in relationship to the performance of the company (Haynes & Boone 1-16).

**Shareholder Say on Pay:** Now that investors will be privy to the pay of the employees of the company in relationship to the performance of the company, they will also have the ability to vote on the compensation of the senior executives of the company. Public companies will issue a non-binding vote to the shareholders in the proxy statement at least once every three years. Included in the proxy will be information from the ‘independent’ compensation committee detailing the support for the pay of the senior executives through comparable statistics of similar companies along with a vote on how often a vote should occur. Further, investors will have an opportunity to review new information in the proxy prior to approving an acquisition, merger or sale of assets. This new information includes details of executive compensation arrangements such as ‘golden parachute’ payments to senior executives in conjunction with the proposed transactions. While these votes are non-binding, they are expected to influence how compensation committees determine pay as investors will now have more information than before and could potentially vote with their wallet and chose to invest in another company (Haynes & Boone 1-16).

While neither of the above changes will likely have a significant impact on REITs, the Act is making an attempt to increase transparency to the investors through proxy statements provided by the company. At the end of the day, these changes will not directly impact a company’s ability to conduct their business, as these votes are non-binding. We believe that level of investor concern over compensation for REIT executives will ultimately be determined by the performance of the investment. Investors who hold shares of REITs that are providing satisfactory investment yields are less likely to vote against market rate executive compensation packages.
CHAPTER 3 – INTERVIEW RESULTS

3.1 Introduction

In Chapter 2, we discussed how the Dodd-Frank Act has changed financial regulation in the U.S. and focused on the provisions that will impact real estate equity investment companies. In this chapter we will take a closer look at the magnitude of these changes from the perspective of a real estate equity investment company. We will assess the additional cost of compliance as well as the volume of change in a company’s daily business operations.

In the article, *US Financial Regulatory Reform: Cost or Opportunity? Impact of The Dodd-Frank Wall Street Reform Act*, consulting firm Accenture estimates that large investment banks and systemic insurance companies are the types of financial firms that will have the highest expected cost of compliance and the highest volume of change in their business operations due to new regulations with the Dodd-Frank Act. **Figure 11** illustrates the estimated cost and volume of change imposed on different categories of financial firms due to new regulation.

![Figure 11: Dodd-Frank Regulation Change Impact Assessment](image)

We will estimate where real estate equity investment companies fall in Figure 11 relative to other types of investment companies by interviewing a sample of private real estate funds, as well as REITs, to gain insight on how new regulation is effecting the real estate investment industry at the entity level. It is important to realize that the costs associated with compliance will likely affect the larger systemic institutions far less than a smaller firm. That being said, a yearly compliance cost of $500,000 will have a much greater impact on a small private real estate fund with a fund size of $500M than it would on a company like Blackstone with gross assets of $36.8B.

3.2 Interview Methodology
The purpose of our interviews was to gain a better understanding of how new regulation is affecting the real estate industry at the entity level, compare impacts to private firms vs. public firms, and impacts to large firms vs. smaller firms. We presented company representatives with a list of questions that can be found in Appendix E and asked for their opinion on how new regulation within the Dodd-Frank Act will affect their company. We felt it was important to allow the interviewees to comment on issues outside of our prepared list of questions because they are intimately involved with the intricacies of how this new regulation will impact their firm.

3.3 Interview Results
We have organized our interviews in order of how they are impacted by new regulation with those impacted least listed first.

Company A
Company A publicly traded REIT that invests in core real estate markets across the country. They have over 650 employees and their gross assets under management total over $15 billion as of March 31, 2012.

We interviewed a senior member of the company’s in house counsel who stated that he believes new regulations within the Dodd-Frank Act have not significantly impacted Company A. The firm is a publicly traded company and was regulated by the SEC prior to the Dodd-Frank Act.
Although new regulation allows for a non-binding shareholder vote on executive compensation, the interviewee does not think it will have a significant impact on executive salaries. He believes that if the company is out-performing its competitors, investors will want to keep the current executives in place, who will need to be paid a competitive market salary to do so. The interviewee also stated that although investors are now getting more information on executive compensation, they are not receiving any additional investment information due to new regulation in the Dodd-Frank Act. Company A believes that investors are ultimately concerned with the performance of their investment and if the investment is performing well, they will not be overly concerned with executive compensation.

The interviewee also discussed a potential unintended consequence of the revised definition of a “commodity pool” in Title IX of the Dodd-Frank Act. Since the new definition of a commodity pool now includes “any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including any commodity for future delivery, security futures product, or swap” there is a chance that REITs could be subject to CFTC regulation if they hold any swaps to hedge against interest rate risk. This is an issue that Company A is currently discussing with NAREIT (the National Association of Real Estate Investment Trusts). They believe that they will be able to get a no action letter from the CFTC, granting equity REITs relief from this definition. Company A believes that the intent of including swaps in this definition is to reduce investment risk. However, Company A is using swaps to help reduce the potential for decreased investment yield due to interest rate risk. They are not using swaps as a means to generate primary investment yield. The interviewee could not provide an estimated cost associated with CFTC regulation when asked to do so.

Company B

Company B is a publicly traded REIT that invests in Class B industrial property across the country. They have approximately 30 employees and their balance sheet is approximately $700 million.

We interviewed the Chief Financial Officer who stated that Company B is largely unaffected by new regulation in the Dodd-Frank Act because they went public after the Act was signed.
Therefore, they were fully aware of new regulation requirements as they were staffing their company and did not experience any significant costs due to new requirements.

He believes that transparency and thorough disclosure is good for both investors and financial firms in the long run because it helps manage investor expectations. He does not think that the shareholders’ ability to vote on executive compensation will have an affect on Company B or the industry because the vote is non-binding and shareholders cannot demand that executives be paid less than market compensation.

Company B did not raise the issue of CFTC regulation due to the revised definition of a commodity pool as a concern. This indicates that not all firms are focused on this issue and further demonstrates the different interpretations of the new regulations within the Dodd-Frank Act.

**Company C**

Company C is a large publicly traded investment company with total assets under management of over $3 trillion across multiple investment platforms including equity, fixed income, cash management, alternative investment, and real estate. Their real estate investment platform manages private real estate funds as well as real estate debt investments globally. Company C is one of the top U.S. managers of real estate funds based on gross assets under management.

We interviewed one of Company C’s managing directors who is responsible for managing their private real estate funds and in his opinion, new financial regulation within the Dodd-Frank Act will not have a significant impact on Company C or its private real estate fund. Although our interviewee is a manager of a private real estate fund, Company C is a large publicly traded company that manages a wide range of investments outside of the real estate industry. He told us that Company C was already subject to government regulation prior to Dodd-Frank and that they were already staffed to handle reporting requirements. Any additional costs associated with legal fees or compliance staff are insignificant to a company of their size. Therefore, there are no significant costs or daily workflow changes associated with the reporting requirements of Dodd-Frank for Company C.
**Company D**

*Company D* manages a private real estate fund that invests solely in institutional quality real estate in primary North American markets. Their gross assets under management are between $800-$900 million between two funds. The first fund has 9 investors and the second fund has 33 investors. There is only one common investor in both funds.

We interviewed *Company D*’s Chief Compliance Officer, who is also their in-house counsel. She was hired on as an additional staff member to help comply with Dodd-Frank regulation and SEC registration. *Company D* was not registered with the SEC prior to Dodd-Frank, but since they can no longer use the private fund exemption that was revised in the Act, they are now registered. Based on their fund size, they filed part 1 and part 2 of the form ADV, as well as section 1 of the form PF. They did not have to file section 2 of the form PF or meet the more stringent requirements for hedge funds and large private real estate funds since their gross assets under management do not meet that threshold.

The Chief Compliance Officer (CCO) stated that most of the costs associated with registration would be a one time initial cost. *Company D* hired consultants and spent money on legal fees to gain a better understand of the registration process since they had never registered before. Now that their reporting procedures are in place they will not incur these same legal and consulting fees. Their only ongoing costs will be the yearly salary for their CCO and a few man-hours per week spent by existing staff that may need to deal with new compliance issues. The interviewee was unable to quantify how many additional man-hours would be spent on ongoing compliance, but told us that they have spent between $125K - $150K of upfront costs to register with the SEC.

Although there are additional costs associated with SEC registration, *Company D* is not interested in figuring out a way to restructure the firm to gain an exemption. The CCO stated that *Company D* wants to register with the SEC because their investment board believes that there is a possibility pension funds and other large investors will be less likely to invest with companies not registered with the SEC.
Company D does not typically raise capital through banking entities looking to invest in real estate so they believe that they will be unaffected by the Volcker Rule which may prohibit banking entities from investing in private equity.

Company D stated that they are not disclosing any new information to their investors due to Dodd-Frank regulation. However, they are being more cautious about making sure that all investors receive the same information. Additional disclosure and transparency is not an issue for the firm. They are strong believers in being transparent with their investors since they have a fiduciary responsibility to their clients.

Company E

Company E manages a private real estate fund that invests in commercial real estate primarily in the Northeast region. Their current gross assets under management are approximately $250 million. Company E has not yet registered with the SEC, but is in the process of doing so as of July 18, 2012. We interviewed the President of the company.

The President of Company E stated that the estimated direct and indirect costs associated with new registration requirements are approximately $500,000 across two funds. The interviewee could not provide a breakdown for this figure but stated that it is comprised of legal fees, consulting fees, and lost productivity from staff members devoting time to new compliance requirements. They are not hiring a new employee to serve as the CCO. Members of their current staff will fill this role.

Although there are additional costs associated with SEC registration, Company E is not interested in figuring out a way to restructure the firm to gain an exemption. The President stated that the company wants to register with the SEC because they believe that pension funds and other large investors will chose not to invest with companies that are not registered with the SEC.
Company E has been advised by their outside counsel that they are subject to filing form ADV because they are a registered investment adviser. However, they do not plan on filing any portion of the form PF. This is a departure from our understanding of form PF guidelines and further demonstrates the inconsistent interpretations of filing requirements under the Dodd-Frank Act. We believe that they are relying on exemption 3(c)(5) of the Investment Company Act as discussed in Chapter 2, but were unable to confirm this in the interview.

Company E does not typically raise capital through banking entities looking to invest in real estate so they believe that they will be unaffected by the Volcker Rule which may prohibit banking entities from investing in private equity.

The interviewee stated that he feels that having to disclose side letters to all investors will have an impact on investor agreements for future funds. He believes that once an investor sees the terms that other investors are getting, they will want the same terms, making it more difficult to manage investor expectations. Investors that are contributing larger amounts of capital often receive more favorable investment terms. He is concerned that these new disclosures will impact their relationship with investors, as well as their ability to negotiate preferential terms with their lead investors.

The interviewee felt strongly that regulation of private real estate funds is an unintended consequence of the Dodd-Frank Act. He stated that public securities were a major contributing factor to the financial crisis of 2008 and are the type of systemic investments the regulation is intended to target. He believes that private real estate funds are not systemic and, therefore, should not be regulated.

Company F

Company F manages a private real estate fund that invests in commercial real estate and targets value-added investment opportunities. Their gross assets under management total approximately $500 million.
When we requested an interview from *Company F* they responded that they did not plan to register as an investment adviser because they have been advised by their outside counsel that their investments do not fall within the definition of a security. *Company F* declined our request for a formal interview citing concerns of attracting unwanted attention as they are currently in the process of raising investment capital for a new fund. The profile of *Company F* is very similar to the profiles of *Company D* and *Company E*. This position is a departure from the interpretation of the majority of private real estate funds.
CHAPTER 4 – ANALYSIS AND CONCLUSIONS

4.1 Introduction
Throughout our study of financial regulation in the US we have explored the regulatory progression from 1863 to present day, highlighted the causes that led to the financial collapse in 2008, and analyzed the implications of the Dodd-Frank Act for real estate investment entities. We interviewed a sample of these investment entities and focused on how they have responded to the new regulatory oversight and reporting requirements and what impact, if any, these new regulations have on their businesses. In this final chapter we will analyze our interview results in terms of the stated goals of the Dodd-Frank Act and assess if the new regulatory framework is furthering those goals with respect to the regulation of the real estate equity investment industry.

4.2 Cost of Compliance

4.2.1 REITs
After interviewing a sample of firms we have found that public REITs are generally not impacted by the Dodd-Frank regulation. REITs are public companies that were already regulated by the SEC prior to the Dodd-Frank Act. Changes to financial regulation within the Dodd-Frank Act are more of an enhancement of existing regulation rather than entirely new regulatory standards for public REITs. These companies are already staffed with compliance officers and rigorous SEC reporting procedures are a normal course of their business operation. As discussed in Chapter 2, there is new regulation within the Dodd-Frank Act that allows investors to vote on executive compensation. However, the firms we spoke with indicated that they would be unaffected by a shareholder ‘say on pay’. They stated that they have always made information on executive compensation available to their investors and if compensation packages were not in line with market standards, people would not invest in their company. They also noted that the investor vote on executive compensation is non-binding. Therefore, they do not feel that giving investors the ability to vote on executive compensation with impact their daily business.
4.2.2 Private Real Estate Funds

Based on our interviews and research, private real estate funds are experiencing different levels of financial burden based on the size of the company. Large firms that are managers of multiple investment products, such as Company C, are largely unaffected by new regulation within the Dodd-Frank Act. Similar to public REITs, they were already regulated by the SEC due to the size of their company and range of their investment types. However, we found that smaller private real estate funds are experiencing a financial burden due to new regulation. Regardless of the magnitude of these costs, companies are spending money on legal and consulting fees, hiring new compliance officers, and losing productivity from staff members who are devoting their time to compliance issues rather than investment issues, all of which they were not required to do prior to the Dodd-Frank Act. However, most of the costs seem to be one-time upfront costs associated with establishing new reporting procedures and obtaining legal advice on how new regulation applies to their firm.

4.3 Accomplishing the Goals of Dodd-Frank

4.3.1 Transparency for Investors

One of the goals of the Dodd-Frank Act is to provide investors with additional transparency in the investment market place to help protect them from abusive financial practices. Based on the results of our interviews, we found that new regulations within the Dodd-Frank Act are enhancing existing disclosure requirements for public equity REITs through required proxy statements. These statements will help investors by providing additional information on underlying investment practices and a level of control of corporate governance through a non-binding vote. We feel that increased transparency is important for an industry where investors may not have the expertise to conduct their own due-diligence on the underlying investment assets. In addition to the benefits of increased transparency in this market, there are also minimal costs associated with the changes in regulation. At the same time, we found that the actual business practices of REITs have been largely unaffected by this change in regulation since public companies were already subject to SEC regulation prior to the Dodd-Frank Act.
With respect to private real estate funds, we found that new regulation has required fund managers to register with the SEC and disclose additional information about the terms of their financial agreements with other investors in the fund. Fund managers in our interviews indicated that they are concerned that these new requirements could impact their relationship with investors, as they are now required to share the terms of individual investment agreements with all members invested in the fund. However, we believe increased transparency is generally beneficial for investors. In this case, additional information regarding investment contracts will help investors negotiate more favorable terms with the fund manager.

Although new regulation is helping to provide additional transparency to investors, it is not furthering the stated goals of the Dodd-Frank Act. The intent of the Act is to protect investors against abusive financial practices. In this case, the additional transparency could be beneficial but a private real estate fund is typically regulated by their investors. Private real estate funds are self-regulating due to the level of sophistication in the investor base. If a fund is not performing adequately or managers are not providing adequate disclosure, investors will ultimately find other avenues to place their capital. As reported in the Wall Street Journal on July 24, 2012, the California Public Employees’ Retirement System (Calpers), the nation’s largest pension fund, has decided to move their capital away from pooled funds and into direct one-on-one relationships with operators. The company chose to change their investment strategy to improve disclosure and gain greater control over their investments.

4.3.2 Controlling Systemic Risk
In Chapter 1 we reviewed a brief history of the U.S. financial regulatory system and the events that led to the financial crisis of 2008. Historically, major changes to financially regulation have been in response to a market failure. One of the main contributing factors that led to the crisis of 2008 was the decline of the housing market and the amplified affect it had on the rest of the financial system due to subprime loans in the MBS market.

A parallel can be drawn between an investment in public equity REIT securities and an investment in mortgage-backed securities. Similar to a mortgage-backed securities investor, a public equity REIT securities investor is able to get in and out of their position quickly because
the securities can be traded in a very liquid market. The major difference between these two types of investments is that a public equity REIT security is an equity investment and a mortgage-backed security is a debt investment. However, both are liquid investments they have the potential to be sensitive to market conditions and a decline in value could cause a run on liquidity similar to that seen in the subprime loan crisis. Therefore, there is a benefit to regulation of public REITs because they have the potential to be systemically significant to the U.S. financial system if the industry grows to systemic levels. In addition to the public benefit of regulation, there are also minimal costs. Since public REITs were already required to register with the SEC prior to the Dodd-Frank Act, the new enhanced regulation will not have a significant financial impact to those companies.

Some industry professionals have argued that private real estate funds should not be subject to new regulation requirements within the Dodd-Frank Act because these entities are not systemic to the U.S. financial system. Therefore, government regulation of these companies is not helping to fulfill the goals of the Act. Investing in a private real estate fund is very different from investing in mortgage-backed securities. Although both are types of real estate investment, private real estate funds are illiquid equity investments whereas mortgage-backed securities are liquid debt investments. Those that invest in private real estate funds need to be sophisticated investors. They are entering into contractual agreements with fund managers and need to be knowledgeable institutions with significant capital in order to invest in the fund. Once an investor has committed to the deal it is very difficult to liquidate their position. Fund managers typically have approval rights over an investor’s ability to sell their position and even if the seller obtained approval on the transaction their position would likely be sold at a significant discount. Since these investors typically hold long positions in an illiquid investment it is highly unlikely that a private real estate fund will be systemic to the U.S. financial system because they cannot react to market shifts by quickly pulling their money out of the investment. In his book, Too Big to Save? How to Fix the U.S. Financial System, Robert Pozen states that the same registration and reporting requirements should not apply to venture capital or private equity funds since they are not traders or short sellers. (Pozen, 366)
In addition to being an illiquid investment, private real estate funds also account for an extremely small share of the market. As of July 2012, the total gross assets of registered real estate fund advisers are approximately $485 billion, which makes up less than 1% of the gross assets of all registered advisers. (www.REAlert.com) A firm similar to Company B with gross assets of approximately $850 million only represents a mere 0.0017% of all registered assets. It would be very difficult to argue that a company with such a small market share could be deemed systemically significant to the U.S. financial system. However, based on our interview results, although SEC registration is an inconvenience for most private real estate funds, it is not detrimental to their daily business operation. There is value to regulation if the provisions within the Act are providing additional transparency to investors and additional information that will help the Financial Stability Oversight Council study collective risk in the economy.
4.4 Potential Concerns

We have learned that the new definition of a commodity pool in Title VII of the Act may trigger CFTC regulation for REITs. The new definition of a commodity pool now includes “any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including any commodity for future delivery, security futures product, or swap”. Therefore, there is a chance that REITs could be subject to CFTC regulation if they hold any swaps to hedge against interest rate volatility. Based on our interviews, industry professionals believe this is an unintended result of the Dodd-Frank regulation. REITs are simply using swaps as a way to hedge against inflation risk, not as a primary investment vehicle. Industry professionals are currently seeking an official no action ruling from the CFTC but the end result is still uncertain.

One of the most interesting facts we discovered during our research and interviews is that some firms have chosen not to register with the SEC despite the overwhelming consensus that real estate fund managers fall within the definition of an investment adviser. Westbrook Partners and Shorenstein Properties are the only two companies out of the top twenty managers of U.S. real estate funds that chose not to register with the SEC as of July 2012. In our initial analysis, we thought that these fund managers were only investing in fee simple ownership of real estate, which falls outside the definition of a security, and therefore would not required to register with the SEC as an investment adviser. However, we decided to explore this position further since most larger private real estate funds have complicated structures that include secured interests in their investment property, such as joint venture partnerships. After speaking with a partner at a major U.S. law firm we found that some real estate fund managers that have chosen not to register are still financing their property acquisitions through mezzanine debt or purchasing whole loans, which fall under the regulatory definition of a security as a ‘note’. They are taking the position of ‘substance over form’ and claiming that categorizing mezzanine debt, used to finance the purchase of a property, as a security is not within the legal definition of a security.

This interpretation has not received an official legal ruling to date. Therefore, it is unclear how the SEC will view this position. It is possible that a company could face civil and criminal penalties if they were found guilty of fraud through misrepresentation. However, it is highly
unlikely that this would be the case for companies relying on this position since it is a reasonable interpretation based on our discussions with counsel. Therefore, the likely outcome of a challenge by the SEC is that they are simply forced to register. This again demonstrates the ambiguity surrounding many of the provisions in Dodd-Frank as they apply to the real estate industry. An interesting question to explore is if investors would have any right of action against the fund manager for non-compliance with SEC regulations.

**Top US Managers of Real Estate Funds**

Based on gross assets managed by SEC-registered advisors. Figures adjusted for J.P. Morgan and estimated for two nonregistered advisors**:

Shorenstein Properties and Westbrook Partners

<table>
<thead>
<tr>
<th>Company</th>
<th>Gross Assets ($Mil.)</th>
<th>Market Share (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Blackstone</td>
<td>$36,805.00</td>
<td>7.6</td>
</tr>
<tr>
<td>2 Lone Star Funds</td>
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<td>6.6</td>
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<tr>
<td>3 Prudential Investment Management</td>
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<td>4 J.P. Morgan</td>
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<tr>
<td>5 <strong>Westbrook Partners</strong></td>
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<tr>
<td>6 Goldman Sachs</td>
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<td>7 Clarion Partners</td>
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Source: www.REAlert.com

**Figure 13: Top Managers of U.S. Real Estate Funds**
4.5 Conclusion

Based on our research and the results of interviews with industry professionals, real estate equity investment entities will experience some level of financial burden due to new regulations within the Dodd-Frank Act, regardless of their magnitude or significance. In order for new regulation to be fair there must be a benefit to the costs associated with regulation. In his book Too Big to Save: How to Fix the U.S. Financial System Robert Pozen states that “fairness means that those who bear the cost of any strategy also are likely to enjoy its benefits.” (Pozen 356) Even if the firms that are bearing the financial burden of regulation are not receiving a direct benefit, they will receive the indirect benefit of a strengthened financial system if the goals of the Dodd-Frank Act are accomplished.

As discussed in Section 4.3, although there are benefits to new regulation, the burden imposed on the real estate equity industry does not help to further the stated goals of the Act. We believe that the regulation focused on debt markets is a more effective way of controlling systemic risk in the U.S. financial system based on our research of the events leading up to the financial crisis of 2008. Prior to the 2008 crisis, abusive lending practices created high-risk investments, the effects of which were compounded by the use of derivatives in a parallel banking system. When real estate values declined and liabilities exceeded the value of the investment, the country experienced a wide spread failure in the financial system. Investment managers use debt as an instrument to create higher returns for their investors. However, this additional leverage also increases risk because debt service payments add to the liabilities of an investment. If Dodd-Frank is effective in regulating debt markets to reduce systemic risk it seems reasonable to conclude that risk reduced in debt investments will ultimately reduce the risk in equity markets. In general, we agree with the goals that the Dodd-Frank Act is trying to accomplish. However, we feel that the regulation of the real estate equity industry, which represents a small portion of the U.S. capital market, is not helping further the stated goals of the Dodd-Frank Act.
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APPENDIX A: EXCERPTS FROM THE INVESTMENT ADVISERS ACT OF 1940

SEC 203(b)(3)….any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under title I of this Act, or a company which has elected to be a business development company pursuant to section 54 of title I of this Act and has not withdrawn its election. For purposes of determining the number of clients of an investment adviser under this paragraph, no shareholder, partner, or beneficial owner of a business development company, as defined in this title, shall be deemed to be a client of such investment adviser unless such person is a client of such investment adviser separate and apart from his status as a shareholder, partner, or beneficial owner.
APPENDIX B: EXCERPTS FROM THE INVESTMENT COMPANY ACT OF 1940

SEC. 3. (a)(I) When used in this title, “investment company” means any issuer which—
(c) Notwithstanding subsection (a), none of the following persons is an investment company within the meaning of this title: (I) Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities. Such issuer shall be deemed to be an investment company for purposes of the limitations set forth in subparagraphs (A)(i) and (B)(i) of section 12(d)(1) governing the purchase or other acquisition by such issuer of any security issued by any registered investment company and the sale of any security issued by any registered open-end investment company to any such issuer. For purposes of this paragraph:
(A) Beneficial ownership by a company shall be deemed to be beneficial ownership by one person, except that, if the company owns 10 per centum or more of the outstanding voting securities of the issuer, and is or, but for the exception provided for in this paragraph or paragraph (7), would be an investment company, the beneficial ownership shall be deemed to be that of the holders of such company’s outstanding securities (other than short-term paper).
(B) Beneficial ownership by any person who acquires securities or interests in securities of an issuer described in the first sentence of this paragraph shall be deemed to be beneficial ownership by the person from whom such transfer was made, pursuant to such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title, where the transfer was caused by legal separation, divorce, death, or other involuntary event.

(5) Any person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in one or more of the following businesses: (A) Purchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services; (B) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and (C) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.

(7)(A) Any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities. Securities that are owned by persons who received the securities from a qualified purchaser as a gift or bequest, or in a case in which the transfer was caused by legal separation, divorce, death, or other involuntary event, shall be deemed to be owned by a qualified purchaser, subject to such rules, regulations, and orders as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
(B) Notwithstanding subparagraph (A), an issuer is within the exception provided by this paragraph if— (i) in addition to qualified purchasers, outstanding securities of that issuer are beneficially owned by not more than 100 persons who are not qualified purchasers, if— (I) such persons acquired any portion of the securities of such issuer on or before September 1, 1996; and (II) at the time at which such persons initially acquired the securities of such issuer, the issuer was excepted by paragraph (1); and (ii) prior to availing itself of the exception provided by this paragraph— (I) such issuer has disclosed to each beneficial owner, as determined under paragraph (1), that future investors will be limited to qualified purchasers, and that ownership in such issuer is no longer limited to not more than 100 persons; and (II) concurrently with or after such disclosure, such issuer has provided each beneficial owner, as determined under paragraph (1), with a reasonable opportunity to redeem any part or all of their interests in the issuer, notwithstanding any agreement to the contrary between the issuer and such persons, for that person’s proportionate share of the issuer’s net assets. (C) Each person that elects to redeem under subparagraph (B)(ii)(II) shall receive an amount in cash equal to that person’s proportionate share of the issuer’s net assets, unless the issuer elects to provide such person with the option of receiving, and such person agrees to receive, all or a portion of such person’s share in assets of the issuer. If the issuer elects to provide such persons with such an opportunity, disclosure concerning such opportunity shall be made in the disclosure required by subparagraph (B)(ii)(I). (D) An issuer that is excepted under this paragraph shall nonetheless be deemed to be an investment company for purposes of the limitations set forth in subparagraphs (A)(i) and (B)(i) of section 12(d)(1) relating to the purchase or other acquisition by such issuer of any security issued by any registered investment company and the sale of any security issued by any registered open-end investment company to any such issuer. (E) For purposes of determining compliance with this paragraph and paragraph (1), an issuer that is otherwise excepted under this paragraph and an issuer that is otherwise excepted under paragraph (1) shall not be treated by the Commission as being a single issuer for purposes of determining whether the outstanding securities of the issuer excepted under paragraph (1) are beneficially owned by not more than 100 persons or whether the outstanding securities of the issuer excepted under this paragraph are owned by persons that are not qualified purchasers. Nothing in this subparagraph shall be construed to establish that a person is a bona fide qualified purchaser for purposes of this paragraph or a bona fide beneficial owner for purposes of paragraph (1).
APPENDIX C: EXCERPTS FROM THE FORM ADV ISSUED BY THE SEC

In determining the amount of your regulatory assets under management, include the securities portfolios for which you provide continuous and regular supervisory or management services as of the date of filing this Form ADV.

(1) Securities Portfolios. An account is a securities portfolio if at least 50% of the total value of the account consists of securities. For purposes of this 50% test, you may treat cash and cash equivalents (i.e., bank deposits, certificates of deposit, bankers acceptances, and similar bank instruments) as securities. You must include securities portfolios that are:
   (a) your family or proprietary accounts;
   (b) accounts for which you receive no compensation for your services; and
   (c) accounts of clients who are not United States persons.
For purposes of this definition, treat all of the assets of a private fund as a securities portfolio, regardless of the nature of such assets. For accounts of private funds, moreover, include in the securities portfolio any uncalled commitment pursuant to which a person is obligated to acquire an interest in, or make a capital contribution to, the private fund.

(2) Value of Portfolio. Include the entire value of each securities portfolio for which you provide continuous and regular supervisory or management services. If you provide continuous and regular supervisory or management services for only a portion of a securities portfolio, include as regulatory assets under management only that portion of the securities portfolio for which you provide such services. Do not deduct any outstanding indebtedness or other accrued but unpaid liabilities.

(3) Continuous and Regular Supervisory or Management Services.
General Criteria. You provide continuous and regular supervisory or management services with respect to an account if:
(a) you have discretionary authority over and provide ongoing supervisory or management services with respect to the account; or
(b) you do not have discretionary authority over the account, but you have ongoing responsibility to select or make recommendations, based upon the needs of the client, as to specific securities or other investments the account may purchase or sell and, if such recommendations are accepted by the client, you are responsible for arranging or effecting the purchase or sale.
APPENDIX D: EXCERPTS FROM THE DODD-FRANK ACT

SEC. 721. DEFINITIONS
(47) SWAP
‘(A) IN GENERAL- Except as provided in subparagraph (B), the term 'swap' means any agreement, contract, or transaction--
‘(i) that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind;
‘(ii) that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence;
‘(iii) that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred, including any agreement, contract, or transaction commonly known as--
‘(I) an interest rate swap;
‘(II) a rate floor;
‘(III) a rate cap;
‘(IV) a rate collar;
‘(V) a cross-currency rate swap;
‘(VI) a basis swap;
‘(VII) a currency swap;
‘(VIII) a foreign exchange swap;
‘(IX) a total return swap;
‘(X) an equity index swap;
‘(XI) an equity swap;
‘(XII) a debt index swap;
‘(XIII) a debt swap;
‘(XIV) a credit spread;
‘(XV) a credit default swap;
‘(XVI) a credit swap;
‘(XVII) a weather swap;
‘(XVIII) an energy swap;
‘(XIX) a metal swap;
‘(XX) an agricultural swap;
‘(XXI) an emissions swap; and
‘(XXII) a commodity swap;
‘(iv) that is an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap;
'(v) including any security-based swap agreement which meets the definition of ‘swap agreement’ as defined in section 206A of the Gramm-Leach-Bliley Act (15 U.S.C. 78c note) of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein; or
‘(vi) that is any combination or permutation of, or option on, any agreement, contract, or transaction described in any of clauses (i) through (v).
APPENDIX E: PREPARED INTERVIEW QUESTIONS

Interview questions for *private real estate funds*

i. What is your AUM and how many funds?
ii. How many employees do you have?
iii. Are you a subsidiary of a larger financial institution?
   1. If yes, how do you anticipate the Volker rule to impact your business?
iv. What new information, if any, will you be required to report to investors and the SEC?
v. Is there an additional cost associated with reporting requirements?
   1. One time
      a. 3rd Part Costs: Legal, consulting, filing
      b. Additional staff hours
      c. Additional hires
   2. On going
      a. 3rd Part Costs: Legal, consulting, filing
      b. Additional staff hours
      c. Additional hires
vi. Do you feel that Dodd-Frank will impact your investment philosophy and are you concerned that you could be deemed systemic to the US financial system which could impose significant restrictions on your business including:
   1. The amount and types of assets under management
   2. Use of leverage
   3. Investment positions
   4. Valuation policies and practices
   5. Side arrangement or letters
   6. Trading practices
vii. Can investors sell their interests in the fund prior to maturity? Is it even possible?
viii. How many investors were in your typical fund prior to Dodd-Frank?
   1. Will this change due to Dodd-Frank and if so, why?
ix. Do you feel that new regulations will make it harder to raise funds from investors and if so, why?
x. Will you explore ways to structure around Dodd-Frank regulations by seeking shelter through limited exemptions including: intrastate or foreign private adviser? What are some of the structures you have considered?

*Please let us know if there is any other pertinent information relating to our topic that you would like to include.*
Interview questions for public equity companies

i. What is your total AUM?
ii. Does Dodd-Frank impose reporting requirements in addition to what you’re already reporting to your investors and the SEC? What are they?
iii. Is there an additional cost associated with any new reporting requirements?

1. One time
   a. 3rd Part Costs: Legal, consulting, filing
   b. Additional staff hours
   c. Additional hires

2. On going
   a. 3rd Part Costs: Legal, consulting, filing
   b. Additional staff hours
   c. Additional hires
   iv. Do you feel that Dodd-Frank will impact your investment philosophy and are you concerned that you could be deemed systemic to the US financial system which could impose significant restrictions on your business including:

3. The amount and types of assets under management
4. Use of leverage
5. Investment positions
6. Valuation policies and practices
7. Side arrangement or letters
8. Trading practices
   v. Does title IX, Investor Protections and Improvements to the Regulation of Securities of Dodd-Frank, increase the information available to shareholders by improving investor protections, closing regulatory gaps, and increasing disclosures through:

9. Compensation Proxy Disclosures
10. Clawback Requirements
11. Shareholder Say on Pay and Say on Change of Control Pay
12. Proxy Access and Corporate Governance
13. Increasing Regulatory Enforcement and Remedies
And if so, in what ways and what can investors now do with that information or what questions do they now answer that they couldn’t do before?

Please let us know if there is any other pertinent information relating to our topic that you would like to include.