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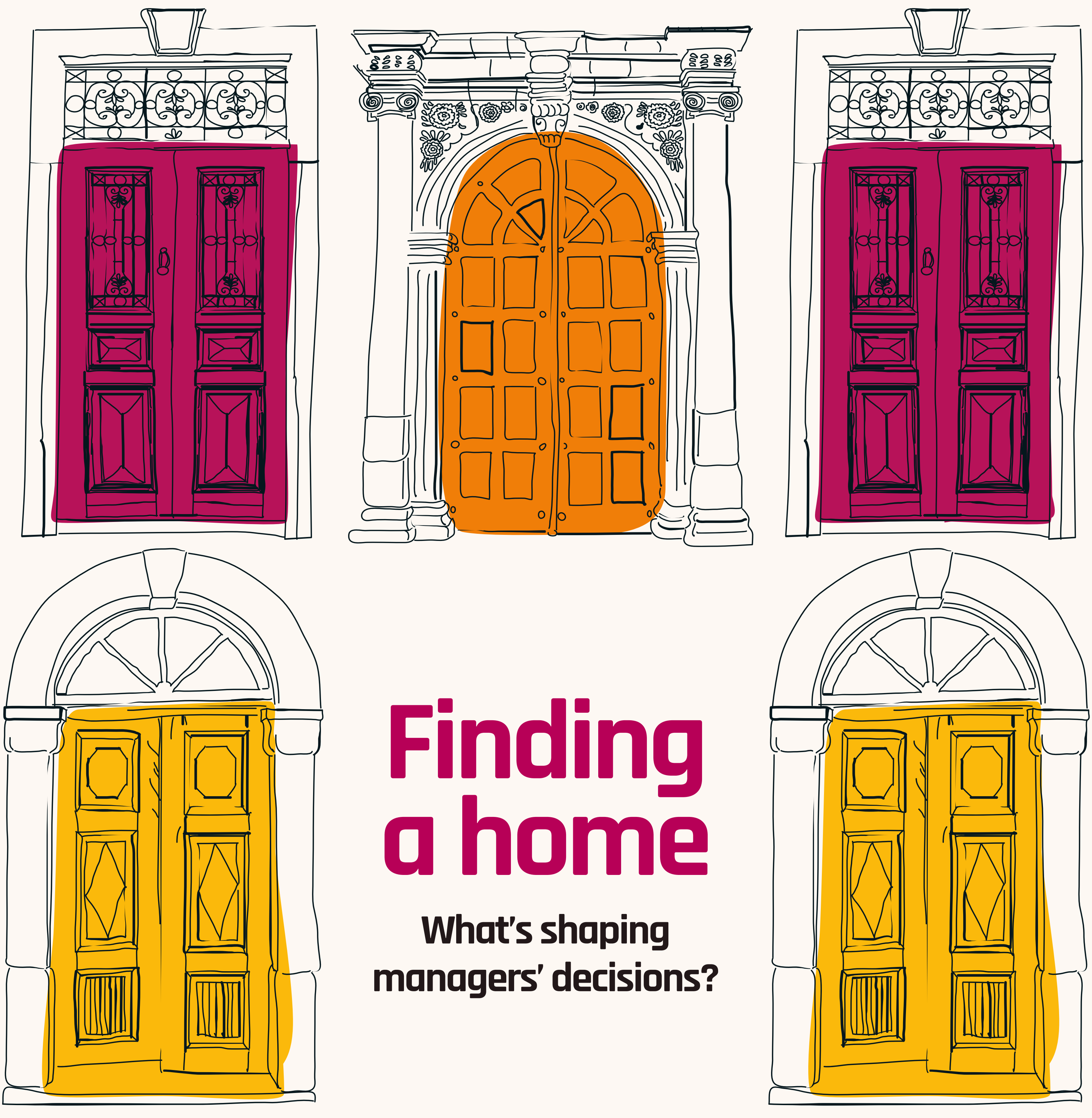

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Light regulatory hand keeps US ship steady

Investors put more pressure on American managers than regulators today. However, data security and capital gains tax may prove more of a headache in the future. By Mark Cooper

The US has been a relatively benevolent domicile and regulatory environment for private real estate funds in recent years, and the good news is that everyone expects this to continue in the near future.

However, there is regulatory pressure with regard to things such as data privacy and security, which affect all businesses, and the possibility of changes to the US capital gains tax regime, which would affect real estate, but not all investors.

Furthermore, regulation is not always just about the regulators. Investors, especially European ones, are demanding more and more disclosure and discipline from managers regarding environmental, social and governance matters, and tend to be ahead of the regulators in this regard.

Stuart Wood, managing director, sales, North America at fund services group Alter Domus, says: "Within the real estate market, there hasn't been any sweeping regulatory change in the US for a while. I think a lot of managers primarily want to make sure that they are staying up to date with what is required from a reporting and disclosure standpoint. Their concerns tend to be around what their peers and colleagues are doing, and how they can be consistent."

Investors have been particularly demanding in recent months, keen to see how managers and the systems they have in place react to the demands of the covid-19 pandemic.

"The investor relations burden is heavier for managers as investors have demanded more information during the covid epidemic," explains Troy Merkel, partner at RSM US. "Managers' investor relations teams have been having to do monthly calls, or in some cases weekly, with investors to give them updates as to what was going on."

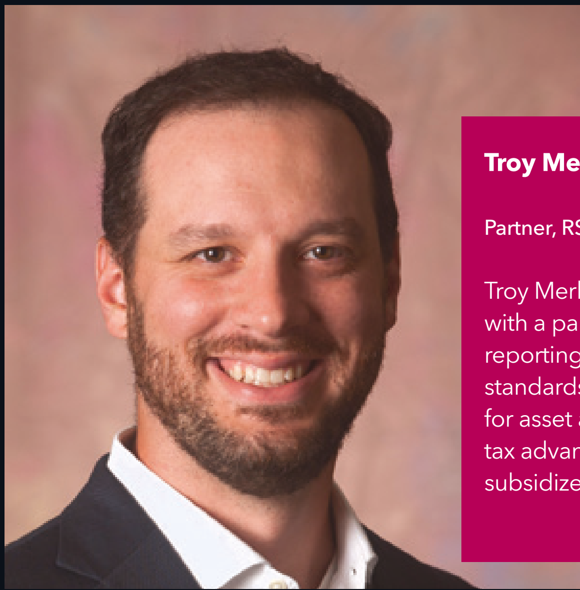
One area where there is pressure

$100bn

Amount that US Treasury secretary Steve Mnuchin estimated back in 2018 would be invested through the opportunity zone program

$10bn

Actual amount raised as of the start of 2020 through the program, according to Novogradac



Troy Merkel

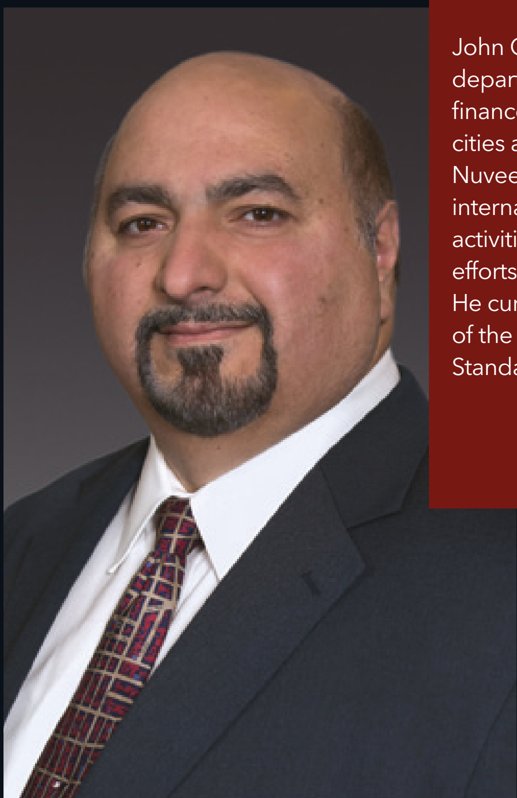
Partner, RSM US

Troy Merkel has 17 years of experience in audit and consulting, with a particular emphasis in real estate and financial services reporting, in accordance with US GAAP, IFRS, NCREIF PREA reporting standards and income tax basis. He is also an expert in accounting for asset acquisitions and complex leases and specializes in various tax advantages, in particular opportunity zones and government subsidized deal structures.

John Caruso

Managing director and global head of fund finance, Nuveen

John Caruso leads a department of close to 150 finance professionals in 10 cities around the world for Nuveen. He is responsible for internal and external reporting activities and also leads global efforts related to fund finance. He currently serves as chairman of the NCREIF/PREA Reporting Standards Council.



Stuart Wood

Managing director, sales, North America, Alter Domus

Stuart Wood is a certified public accountant with over 15 years of experience in the accounting and finance industry. Before joining Alter Domus's business development group, he served as the head of Cortland Capital Markets LLC's fund administration operations. Through years of hands-on experience, Stuart has strong knowledge of applied accounting and reporting for hedge funds, credit funds, real estate and private equity funds.

Opportunity zones: A missed opportunity?

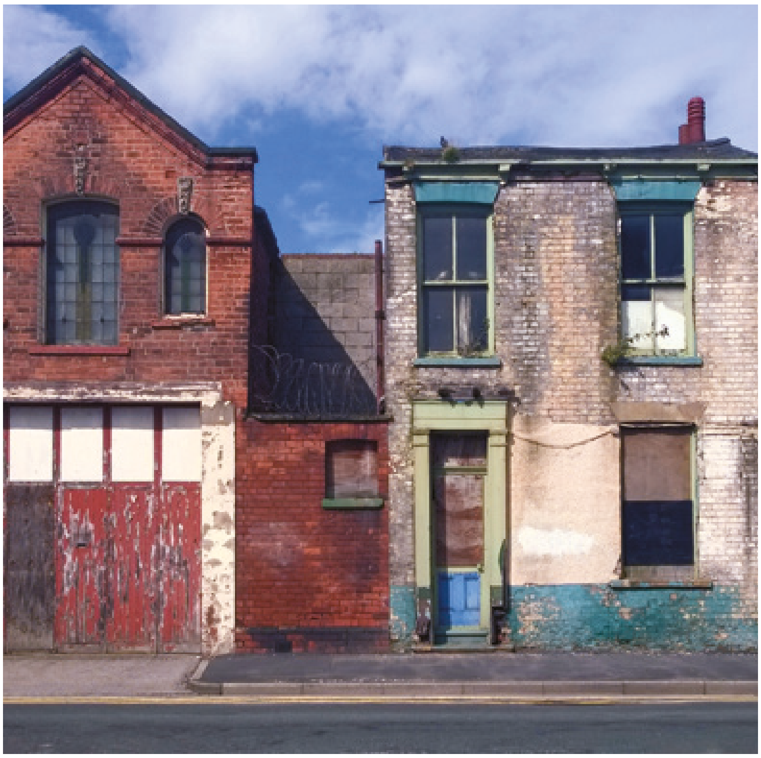
Hailed as a tax-cutting exercise that could regenerate US cities, they have so far failed to take off. But there are hopes legislation might be amended to give it broader appeal

The opportunity zone program allows investors to defer taxes on capital gains by rolling them into investments in designated low-income areas. In 2018, US Treasury secretary Steven Mnuchin estimated that $100 billion could be invested through the program. Novogradac identified 502 funds nationally targeting $68.55 billion in opportunity zones. However, it found that less than $10 billion had been raised as of the start of this year. "It has been a challenge to get a large commingled vehicle up and running," says Stuart Wood, managing director at fund services group Alter Domus. "So, what we ended up seeing were a lot of funds and vehicles set up to just be single-asset funds."

With major US investors being tax-exempt in any case, the pressure to invest in opportunity zones has not been significant.

Troy Merkel, partner at RSM US, says: "Opportunity zones were a hot topic for two years or so, but the focus has dwindled. Ultimately, I hope it is still just a phase one, or 1.0 of the program, and they go to a 2.0 because I do think there's some value-add benefits to it and it could be a way to make sure some neighborhoods get development they wouldn't otherwise."

Any changes to the US long-term capital gains tax regime might also make opportunity zones look more attractive in the future.



from both investors and regulators is regarding data security and privacy, says John Caruso, managing director and global head of fund finance at investment manager Nuveen.

"There's a lot of focus on privacy issues," he says. "For example, California has come out with fairly robust regulations around personal information, which is really changing the way we have to do business as it relates to our multi-family properties.

"This is an issue worldwide too. The UK has adopted a lot of new regulations around privacy and information exchange that is even extending to corporate tenants in our office and retail portfolios. This is impeding our business in that we are a global company and I couldn't even have my UK guy send me a file which relates to some of the properties we own there. We had to jump through multiple legal and compliance hoops internally to finally get the data available on a shared data warehouse.

"As a consequence, we are looking to change the way our platform operates here in the US and overseas as it relates to the multifamily space. Right now, we have a lot of tenant data in our system, but we are trying to segregate that, to keep personal information at the property manager level and just have higher-level data coming into the platform. However, we haven't seen a lot of folks come in and say, 'I don't want to invest in multifamily because the privacy stuff scares me.'"

When it comes to cybersecurity, however, fears over what can go wrong drive behavior more than legislation, says Wood. "If you get your cybersecurity wrong, it can mean front-page headlines, and the reputational risk alone is really too much to handle. So, there is a lot of focus on making sure that you have the right controls in place, the right processes and procedures, but it comes down to the right people as well. We have seen some instances in the past few years where people had the right security and the right process but there was an individual who did not follow that process, or circumvented it somehow and negated everything."

ESG growing pains

Perhaps the largest generator of regulatory headaches for managers worldwide is ESG, and while the US and its states have rules in place, investor pressure is the key factor here, the panelists agree.

"ESG requirements started, as far real estate is concerned, with the European investors coming into the US, demanding attention to it," says Caruso. "Now, we see more and more of the US pension plans hop on that ESG trend and require compliance from managers."

Adds Wood: "Some of our clients have taken steps to create positions such as director of sustainability in order to meet investor demand for more information, such as LEED ratings for the whole portfolio. If managers are going out and marketing to a government pension fund, they need something that meets sustainability metrics and requirements. I don't know that I've seen any legislation in particular driving this; the investors are taking the lead."

US managers need to be aware of legislation at the state level, as well as federal and global regulations, and there is little hope that matters will get any less complex in the future. "I think that primarily the regulatory environment which impacts the real estate world has always stayed at a local level," Merkel says. "The regulatory environment around ESG still stays at the local level for the most part, with a few federal measures."

Seeking harmony

Merkel says that one of the things he dreams of is a more harmonized regulatory environment, at least within the US. "For example, when you're talking about zoning, you're dealing with very local political concerns and they are not always looking out for the broader

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> **Alter Domus**

good. When we look at things like the affordability issues we have had with housing, when we look at retail trying to reposition itself, where you have ghost town malls which can't change because of zoning requirements, a more harmonized national approach would be better."

There isn't much hope internationally either. "Harmonization is difficult," Caruso says. "I'm involved with the NCREIF/PREA Reporting Standards Council in looking at global reporting standards with INREV and ANREV and that alone has been a challenge. I can't see governments really lining up to harmonize regulation across the board. There will be themes though; for example, a focus on ESG and perhaps now diversity. But look at the EU – every country still has its own regulations."

Eye on tax

While domicile and fund structuring are straightforward issues for US investors in US real estate, the globalization of the real estate industry brings complications. Tax optimization is crucial for foreign capital coming into the US and for US capital going overseas.

Wood says: "For a lot of US managers which may not already be global, the question is, 'How do I become global, and what is the right price point to try to do that?' There are a lot of different vehicles and different ways to make things tax compliant for the end investor. However, sometimes when you structure something really complex, you end up negating all of the benefit of the tax mitigation because of the large overhead and operational cost of setting up those types of structures.

"We have seen a continued demand from managers that are trying to figure out how to best meet the demands of the investor without over-complicating things. For example, do they build the structure first in order to attract the investor? Or – and this happens most of the time – do I wait for a key investor and then create the structure to suit them. Then, hopefully, this will attract further investors coming out of similar jurisdictions."

Caruso says: "We recently launched a US cities sector series, we have four open-end sector funds – office, retail, industrial, multifamily. We have interest from foreign investors which are concerned about the tax implications. So, for all four funds, we have set up a Luxembourg feeder which will mitigate some of the tax issues for some of the European clients, particularly German clients."

The US presidential election is set for November and both candidates must consider ways to cover the cost of mitigating the covid-19 pandemic and the accompanying economic downturn. The campaign of Democratic candidate Joe Biden has cited the favorable treatment of long-term capital gains as a potential area of change.

Merkel says: "The Biden campaign has made some comments regarding taxing the investment community and real estate. The campaign proposals for funding his caring economy include changes to capital gains taxes. I think unwinding that could have some significant ramifications. If there are changes to the favorable tax terms for long-term capital gains, there would be a significant impact on the after-tax IRRs for for-profit investors, which have long benefited from these preferential tax treatments."

However, Caruso says many investors in US real estate and clients of US managers are tax exempt. "It might actually provide a buying opportunity if certain taxable investors are trying to get out of real estate, assuming the rest of the economy, or the economics of that particular investment, make sense."

He also notes that federal legislation on tax would likely require one party in control of both House and Senate. "The outcome of the election could be a non-event depending on what happens with the congressional elections; if we end up with a split between House and Senate, nothing is going to get passed anyway."

Nonetheless, Merkel flags tax as something that will be a consideration for any future government. "I think whichever way the election goes, there's going to be another look at tax reform. Both campaigns have talked about that. I believe keeping an eye on tax reform is important. Stay close to your tax advisors so that you know what's coming, so you can plan accordingly."

Looking ahead

The panelists still see a relatively benign regulatory environment for US real estate managers.

"Over the last few years there hasn't been a lot of interference," Wood says. "If anything, most of the regulation has been to help generate more investing in the real estate space. I don't think investors or managers really need to be worried about something coming up in the next few years that's going to drastically shake up how they're investing in real estate from a regulatory and compliance standpoint."

Nonetheless, Caruso says managers also need to keep an eye on the international stage: "In the long term, we will see more legislation around ESG all over the world, primarily focused on environmental sustainability, and some of that might be dramatic and affect everyone."

The post-covid world is likely to have further hurdles for real estate, over data protection for example.

"As we look at how to make buildings touchless, some of that may involve facial scanning and recognition; technologies that exist but which Western culture has been very slow to adopt on a grand scale," Merkel says. "The regulatory implications that are going to come with that could make this an issue going forward for office and retail owners."

Investors and managers cannot be complacent and need to be flexible and resilient in order to deal with future regulatory changes.

"To be ready for legislative change, or any change, is about making sure you have that core resiliency and flexibility, which is something we are talking to a lot of clients about right now," says Merkel.

"Making sure that they have flexibility and resiliency in their portfolio, in their data and in their reporting. So, that way they can adjust quickly if they determine they need to alter their investment strategy."

For some investors and managers, that might mean staying alert and aware of changes, says Wood. "With regard to flexibility and resiliency, a lot of that comes from making sure that you have good access to your data." ■

502

Number of opportunity zone funds as of January 2020, according to Novogradac

$68bn

Target for those funds