



# GENERALLY ACCEPTED PRACTICES FOR RECORDKEEPING PRIVATE REAL ESTATE FUNDS IN DEFINED CONTRIBUTION PLANS

## OBJECTIVE

DCREC, in collaboration with members of the Defined Contribution (“DC”) recordkeeping community, strives to enhance the knowledge and confidence DC Plan Sponsors and their Advisors have in including less liquid asset classes (in particular, private real estate) in multi-asset solutions for DC Plans. The purpose of this paper is to address perceived operational complexities and provide confidence to fiduciaries, record keepers, custodians and other administrative service providers in accessing and administering less liquid options in a daily valued environment. This paper identifies successful implementation models and generally accepted practices for the management of cash flows and potential liquidity restrictions that may occur when using less liquid asset classes within a multi-asset investment offering.

This document was created based on recent experiences with several large defined contribution plan sponsors and their advisor/consultants who have added daily valued, private real estate funds to their plans. DCREC hopes to follow this discussion with a few case studies.

## FUNDAMENTAL PRINCIPLES

- 01** | The private real estate fund (the “**RE Fund**”) is assumed to be a “sleeve” or sub-fund within a larger, professionally managed multi-asset DC option in a participant-directed plan (i.e. target date, target risk, real asset, diversified inflation or multi-manager fund). Such custom designed multi-asset option is often referred to as a white label or “**Custom Fund.**”

This paper does not address offering the RE Fund as a “stand-alone” option in the DC plan’s “core” menu.
  
- 02** | The RE Fund will be daily priced and make daily net asset value (“**NAV**”) information available to DC service providers in a timely fashion. This will generally be done through the National Securities Clearing Corporation (“**NSCC**”) or mutually agreed upon communication medium (i.e. email, fax) prior to 6:30PM Eastern Time each day the New York Stock Exchange is open for trading.

Note: The process for creating a daily NAV for a private Real Estate fund is not the specific subject of this paper. However, DCREC has published specific research on best practices for daily valuation of private Real Estate Funds. This information can be found on our website: [www.DCREC.org](http://www.DCREC.org).

**Real Estate Fund (“RE Fund”)**

- The daily valued fund used by a Custom Fund Investment Manager (and their Plan Advisor/Consultant, if applicable) to diversify investment risks and returns of a custom multi-asset fund
- The daily traded, sub-fund or sleeve of a larger fund managed by a Custom Fund Investment Manager

**Real Estate Fund Custodian**

- Provides RE Fund daily NAV to Custom Fund / DC Plan Custodian
- Monitors RE Fund liquidity rules and notifies authorized parties if changes in Custom Fund cash flow allocations are required

**Custom Fund Investment Manager** (could be the Plan Sponsor or a delegated 3(38) Fiduciary. This might also include an “off-the-shelf” target date manager or a managed account provider)

- Defines, develops and communicates Custom Fund portfolio asset allocation among sub-funds
- Sets, adjusts and directs sub-fund line-up and asset allocation adjustments or modifications through a Letter of Direction (described below) shared with all relevant parties (i.e. Custom Fund Custodian, Record Keeper and the Plan)

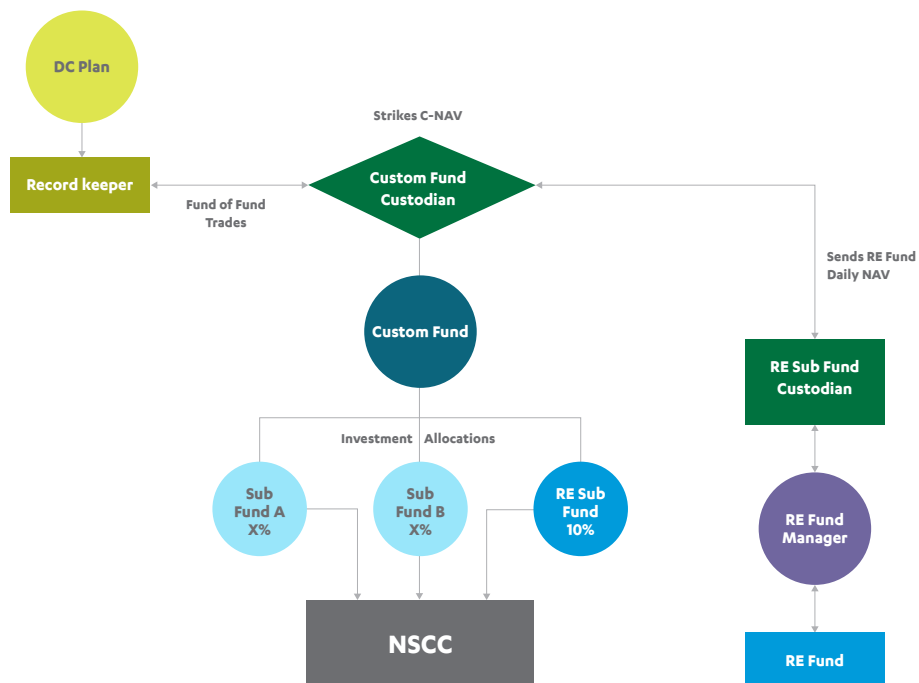
**Custom Fund Custodian** (Target Date or other multi-asset) or DC Plan Custodian\*

- Typically selected by the Plan Sponsor
- Strikes the Custom Fund net asset value (“C-NAV”)
- Executes the allocation of cash flows into and out of the sub-funds of the Custom Fund
- Executes periodic rebalancing of the sub-funds
- Executes the terms of the Letter of Direction (described below), as it may be amended from time to time

**DC Plan Record Keeper\***

- Receives C-NAV from Custom Fund Custodian
- Executes single, daily net trade at Custom Fund level, based on nightly Plan activity

\*DC Plan Custodian and Record Keeper may be affiliated parties or serve dual functions.



- 1) DC Plan participants can contribute to a Custom Fund without any special process.
- 2) At the inception of the Custom Fund, or at the time the RE Fund is added, the Custom Fund Investment Manager will determine the frequency of how contributions will be invested into the RE Fund. For example:
  - a) Direct contributions to the RE Fund on a daily basis
  - b) Direct contributions to a fully liquid sub-fund and rebalance into the RE Fund on a specified schedule (i.e. weekly, monthly or quarterly)
- 3) Managing continued cash flows from Custom Fund participants into the RE Fund requires clear communication and understanding of the RE Fund's policies for receiving ongoing cash flows. One example may be that the underlying private real estate fund has established a quarterly deposit amount that is "reserved" for its daily valued RE Fund. Such policies should include what happens in the case a deposit queue is in place for the RE Fund. For example, the Custom Fund Investment Manager, Custodian and Record keeper may be required to revert to the "alternate allocation" for a period of time. Setting cash flow expectations (either set dollar amounts or otherwise) should be established at the time the RE Fund is added to the Custom Fund.

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## MANAGING CASH FLOWS OUT (REDEMPTIONS)

- 1) DC Plan participants can generally request a redemption from the Custom Fund as needed, without any special process.
- 2) At the inception or inclusion of the RE Fund in the Custom Fund, the Custom Fund Investment Manager will determine the normal investment allocations for each sub-fund that will source redemptions (the "**Normal Allocation**"). Under normal conditions, this will generally be the same as the allocation of ongoing contributions or cash flows into the Custom Fund.
- 3) RE Fund Liquidity Management: The RE Fund manager needs to have a close working relationship with the Custom Fund Investment Manager. The RE Fund manager or RE Fund Custodian will actively monitor cash flow thresholds and communicate liquidity limitations to all authorized parties.
- 4) Custom Fund Liquidity Management: Custom Fund cash flow and cash reserves are typically managed by the plan's Custom Fund Custodian and the Custom Fund Investment Manager. Both parties must agree to partner and proactively monitor cash reserves to ensure RE Fund trades are executed in good order. If redemptions for the RE Fund approach a pre-determined limit set by the RE Fund's investment guidelines, an "**Alternate Allocation**" methodology may be immediately implemented by the appropriate service providers (Custom Fund Investment Manager, Custom Fund Custodian or Record Keeper) who are allocating to the sub-funds of the Custom Fund.
- 5) Letter of Direction: The Normal and Alternate Allocation details and communication processes should be clearly set out in writing in a document that is commonly called a "**Letter of Direction**" (sample provided as **Exhibit A**). These types of agreements are commonly used by custodians in many situations (e.g. Plan Sponsor company stock). Any Letter of Direction should be discussed and agreed upon by all relevant parties at the time the RE Fund is included in the Custom Fund.

The execution of an Alternate Allocation may result in redemptions no longer being sourced from the RE Fund to meet the Custom Fund's redemption needs. For a temporary period at least, redemptions would be sourced from another sub-fund, as defined in the Letter of Direction. This Alternate Allocation remains in effect until the RE Fund manager communicates to the Custom Fund Investment Manager that the RE Fund liquidity limitations are no longer in effect. It is the responsibility of the Custom Fund Investment Manager to direct the Custom Fund Custodian to return to the Normal Allocation.

The NSCC and its Fund Serve trading platform is commonly used as a central clearing place where DC plans operate in a T+1 environment. NSCC trades mutual funds as well as other daily priced funds (i.e. bank collective trusts and insurance company separate accounts) that are not available on a public exchange. Such funds will trade based on CUSIP identifiers.

In the unlikely event of a large, unanticipated net redemption, a T+1 trade through NSCC could trigger a redemption limit and a next day rejected trade from the RE Fund. This event would also result in a short term overdraft for the Custom Fund Custodian. Such single day overdraft may be remedied immediately by executing the Alternate Allocation as defined by the Letter of Direction to allow for trade processing. The above situation would only occur in a reactive situation where a single daily trade triggers the RE Fund redemption limits that were not proactively anticipated through the active management process.

If an overdraft occurs, an overdraft fee may apply, in accordance with the terms of the Custom Fund custodial agreement. The nature of the overdraft fee, if any, will be documented in the custodial agreement and is likely set at a predetermined rate (Prime, LIBOR or some variation of these two rates). These fees are generally small.

**Example:** Potential daily fee for a \$1 million overdraft:  
 $\$1,000,000$  (over draft amount)  $\times$  4.75% (interest rate)  $\times$  1/365 = **\$130**.

(See **Exhibit B** for an example of NSCC trade correction steps)

When a Plan adds a new RE Fund to its investment strategy (as a sleeve or sub-fund of a Custom Fund), agreements to facilitate investment, trading and servicing for the RE Fund are required between applicable parties.

Such agreements include:

- 1. Agreement between the Custom Fund Investment Manager and RE Fund manager:** This agreement documents the Custom Fund's subscription to the RE Fund. Depending on the legal vehicle type (insurance company separate account, bank collective trust or limited partnership), this document is how the Custom Fund Investment Manager facilitates an investment in the RE Fund and commits to an investment amount and the terms of the RE Fund. It typically includes investment guidelines, risks, fees, etc. and may be called a group annuity contract, trust participation agreement or subscription agreement.
- 2. Agreement between the Custom Fund Investment Manager and the Record keeper:** This agreement might be referred to as the "selling and servicing agreement". It will likely cover a wide variety of services; participant statements, on-line access, fees and standard delivery times. This agreement is likely already in place when the RE Fund is added (as it applies to all investment options of the Plan), but should be reviewed to insure the terms are not in conflict with the RE Fund's trading and servicing provisions, especially as it relates to liquidity rules.
- 3. Agreement between the Record keeper/Custodian and RE Fund manager:** If not already included in agreement #2 above, this agreement will typically cover trading and servicing terms (including NSCC trading) between the RE Fund manager and the record keeper/Custodian. It will cover NAV delivery, timing, transfer of funds, and liability for restated or incorrect NAVs, etc. Depending on the RE Fund manager, an existing agreement covering other investment funds (stocks, bonds, etc.) may already be in place to address trading and servicing on the Record keeper's platform. If this is the case, an amendment to the existing agreement may facilitate the addition of the RE Fund and the RE Fund's liquidity rules.

The Custom Fund Investment Manager (and its Advisor/Consultant, if applicable) will be responsible for insuring which documents take precedence if there are any conflicting provisions.

## SUMMARY

Daily traded, private, Real Estate Funds are now being included in over 100 defined contribution plans in the U.S. Real estate is the third largest asset class behind stocks and bonds and has been a fundamental investment of defined benefit plans for decades. The proven long-term stability of returns, strong income, low correlations to stocks and bonds, and relatively higher correlation to inflation over time are compelling reasons to overcome the perceived barriers to broader inclusion of real estate in defined contribution plans. The immense success of QDIA solutions (i.e. target date funds) provides an efficient access point for adding daily valued, private real estate funds to multi-asset investment portfolios. In this way, liquidity constraints can and are being successfully addressed by custodian banks, transfer agents and record keepers by proactively implementing processes such as those described above.

EXHIBIT A: SAMPLE LETTER OF DIRECTION

EXHIBIT B: STEPS TO REMEDY NSCC TRADING IF RE FUND TRADE REJECTED

The Defined Contribution Real Estate Council (“DCREC”) and its members welcome comments and dialogue from industry professionals on this subject. [contact@dcrec.org](mailto:contact@dcrec.org)



Fund Name: Custom Fund (i.e. The ABC Company 2050 Fund)

Effective Date: \_\_\_\_\_ Fund Year End Date: \_\_\_\_\_ Amended Date: \_\_\_\_\_

**Normal Allocation of Cash flow to Sub-Funds**

- 1) Sub-Fund: Real Estate Fund  
CUSIP: Nine digit number/letter  
Allocation target: 10%  
Tolerance range: 5-15%  
Liquidity restrictions: \_\_\_\_\_
- 2) Sub-Fund: S&P 500 Stock Fund  
CUSIP: Nine digit number/letter  
Allocation target: 80%  
Tolerance range: 70-90%
- 3) Sub-Fund: Barclays Aggregate Bond Index  
CUSIP: Nine digit number/letter  
Allocation target: 10%  
Tolerance range: 5-15%

**Cash Flow Allocation Methodology**

- Straight- Split based on a fixed allocation %
- Dynamic- Split based on relative differences between actual and target allocations
- Fixed to Actual- Split based on actual market value percentages

**Rebalancing Methodology**

- Specific Time based Initial date: \_\_\_\_\_
- Frequency (Monthly/Quarterly/Annually)
- Ad Hoc: Between regularly scheduled periods, rebalancing can be initiated by Custom Fund Investment Manager

**Alternate Allocation of Cash Flows to Sub-Funds\***

- 1) Sub-Fund: Real Estate Fund  
CUSIP: Nine digit number/letter  
Allocation target: **0%**  
Tolerance range: **Remains static. May rebalance/transfer into Fund but not out of Fund**  
Liquidity restrictions: **Redemption Restrictions in place until further notice**
- 2) Sub-Fund: S&P 500 Stock Fund  
CUSIP: Nine digit number/letter  
Allocation target: 85%  
Tolerance range: 75-95%
- 3) Sub-Fund: Barclays Aggregate Bond Index  
CUSIP: Nine digit number/letter  
Allocation target: 15%  
Tolerance range: 5-25%

\*temporary implementation of changed investment allocations; in effect until removed by directive from the Custom Fund Investment Manager

Authorization of:  
CUSTOM FUND INVESTMENT MANAGER

Acceptance of:  
CUSTOM FUND CUSTODIAN

By: \_\_\_\_\_

By: \_\_\_\_\_

Title: \_\_\_\_\_

Title: \_\_\_\_\_

Date: \_\_\_\_\_

Date: \_\_\_\_\_

## Assumptions

- Trade Date = effective date of participant trades
- Trade date trades for Plan equal net redemptions
- RE Fund is inside a Custom Fund structure (e.g. target date fund)
- All trades outside of RE Fund settle successfully

## Steps Period

Steps	Period	
1	T+1	Record keeper sends Custom Fund trades to Custom Fund Custodian
2	T+1	Custom Fund Custodian calculates sub-fund fund trades inside Custom Fund
3	T+1	Custom Fund Custodian sends RE Fund trade to NSCC
4	T+1	NSCC sends RE Fund trade to Transfer Agent
5	T+1	RE Fund Transfer Agent processes Custom Fund trades through gates application
6	T+1	RE Fund Transfer Agent rejects RE Fund redemption request via NSCC
7	T+1	NSCC sends rejected trade information to Custom Fund Custodian
8	T+1	Custom Fund Custodian will ensure rejected trade has not posted to Plan Account
9	T+1	Custom Fund Custodian may need to update system to prohibit additional RE Fund trades
10	T+1	Custom Fund Custodian will be overdraft by amount of RE Fund trade
11	T+1	Custom Fund Custodian will consult Custom Fund Investment Manager or Letter of Direction for next steps which may include: <ul style="list-style-type: none"> <li>– Liquidating positions of other sub-funds in Custom Fund using alternate allocation set forth in Letter of Direction</li> <li>– Liquidating positions of other sub-funds in Custom Fund using specific instructions from Custom Fund Investment Manager</li> </ul>
12	T+1	Custom Fund Custodian places liquidating trades to cover the overdraft via NSCC
13	T+2	NSCC transmits redemption trades of other sub-funds to the sub-funds' respective Transfer Agents
14	T+2	NSCC and Custom Fund Custodian settle liquidating trades

\* The **“Transfer Agent”** for the Custom Fund or each sub-fund (including the RE Fund) may be such fund’s custodian or the custodian’s designated service provider.

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