

DIRECT REAL ESTATE IN DC PLANS:

10 KEY PRINCIPLES FOR
PRODUCT STRUCTURES &
INVESTOR ELIGIBILITY

OVERALL GOALS OF PRODUCT STRUCTURE

Compatibility with the needs of the DC market and record keeper systems, institutional quality, transparency, strong investor regulatory protections and cost efficiency

For the purpose of the Principles, real estate interests are defined as either:

“Listed Real Estate” – securities in stock exchange listed equity REITs or stock exchange listed real estate companies; or

“Direct Real Estate” – direct ownership of real estate or investment in an entity, such as a “Private” (as defined below) limited partnership, that directly owns real estate.

Within the context of DC plans, investment in Listed Real Estate or Direct Real Estate typically involves investment in a “product” that invests in the Listed Real Estate or Direct Real Estate, or a combination of both. The product may be either:

“Registered” – meaning that the securities of the product entity are registered with the SEC, such as the securities of mutual funds; or

“Private” – meaning that the securities of the product entity are not registered with the SEC, such as the securities of most Direct Real Estate limited partnerships.

GENERAL PRODUCT

STRUCTURE CONSIDERATIONS

As a general matter, DC Direct Real Estate product structures should accommodate the unique considerations that are important to DC plan fiduciaries such as investor eligibility, regulatory oversight and tax reporting.

EFFICIENT TAX REPORTING

A DC Direct Real Estate product should be structured as a tax-exempt entity or a vehicle that issues an IRS Form 1099 for tax reporting to minimize the administrative burden to plan fiduciaries and record keepers.

MARKET APPROPRIATE VEHICLE

A DC Direct Real Estate product should utilize a structure that reduces unnecessary regulatory, operational and administrative expenses, while still providing an appropriate level of regulatory oversight and investment disclosure.

DC PLAN-CENTRIC PRODUCT

A DC Direct Real Estate product should be tailored to the needs of DC plan investors

The chart attached to this summary of six common product structures provides a high level comparison of certain unique considerations important to DC plan fiduciaries. These considerations are discussed in more detail below.

Bank or trust company collective investment trusts are tax-exempt entities. Insurance company separate accounts, real estate investment trusts (“REITs”), mutual funds, exchange traded funds (ETFs”) and some (but not all) Registered funds issue 1099s to report distributions made to investors, along with the tax characterization of those distributions. Income received from such a 1099 reporting vehicle generally does not trigger any tax or tax reporting for a qualified defined contribution plan.

Entities that are partnerships for tax purposes (including limited partnerships, limited liability companies and certain Registered funds that are K-1 tax reporters) are “flow through” entities for tax purposes. Generally, DC plan record keepers are not equipped to allocate partnership flow through tax liability among affected participant accounts, making entities that are tax partnerships unacceptable for most DC plans.

Due to the higher regulatory filing, compliance, operational and administrative obligations, among other factors, associated with Registered vehicles, Private vehicles such as bank collective trusts and insurance company separate accounts are increasingly preferred by DC plan fiduciaries, when available.

In addition, the market for Registered, non-listed vehicles like interval funds and non-listed REITs, is evolving to suit the institutional market, with some offering share classes sold at par with no sales commissions or other fees beyond asset management.

A Direct Real Estate product designed for the DC market must produce daily valuations and provide at least some level of daily liquidity to meet the needs of most DC plan sponsors and recordkeepers in today’s investment marketplace. DC real estate products may also need to offer multiple classes to address plan needs (e.g., fees billed outside of NAV).

The legal structure may affect investor eligibility. Bank collective trusts and certain insurance company separate accounts limit investors to certain retirement plans, and therefore are particularly tailored to that market. Other entity structures, such as Registered funds and public non-listed REITs are generally open to any investor type and may offer special classes of securities particularly tailored to the retirement plan market.

Registered real estate investment options may also be available through brokerage window platforms for participants who wish to increase their exposure to this asset class and who meet state suitability requirements.

INVESTOR PROTECTIONS

Regardless of the product structure or regulatory oversight, a real estate DC product should offer strong investor regulatory protections

TRANSPARENCY

A DC Direct Real Estate product that invests through a fund of funds structure should provide transparency at all levels

APPROPRIATE INVESTOR ELIGIBILITY

DC Direct Real Estate product investor eligibility (including whether plan participants are permitted to invest directly as a stand alone or core investment option in their plans) should be determined in light of the liquidity, and applicable tax and securities law limitations

Because Direct Real Estate is a relatively new asset class for DC plans, strong regulatory protection for investors is important for such DC real estate products. The structure of the product may affect the regulatory protections; but the structure typically affords either SEC or ERISA regulatory protection. Registered funds, such as public non-listed REITs and Registered investment companies are regulated by the SEC. Bank collective trusts and insurance company separate accounts are regulated by the Department of Labor under ERISA, with the managers of such products and the sponsoring banks or insurance companies serving as ERISA fiduciaries to the investors. Bank collective trusts are also regulated by the OCC or state banking laws and insurance companies are regulated by applicable state insurance laws. Many products are managed by an SEC-registered investment adviser subject to fiduciary standards under the Investment Advisers Act.

If a DC real estate product invests in Direct Real Estate indirectly through one or more underlying funds, plan fiduciaries should receive disclosure regarding the underlying fund manager(s), investment objectives/restrictions and key fund terms. There should also be transparency regarding the overall fees paid to the product manager at all levels.

Products that primarily invest in Direct Real Estate are typically less liquid than other stand-alone investment options on a DC plan menu. In order to reduce the illiquidity risks, plan fiduciaries and product managers often limit the use of Direct Real Estate products within the core investment option menu to sleeves in multi-asset investment solutions (e.g. target date, multi-asset or other diversified funds) where allocations and liquidity can be managed on a scale greater than that of a stand-alone or core investment option.

If plan fiduciaries do offer participants access to Direct Real Estate as a stand alone (core) option or through a brokerage window, plan fiduciaries or product sponsors may impose trading limitations, gates or redemption fees due to the less liquid nature of the assets in the DC real estate product and implement participant education programs on the nature of the investment (as highlighted below).

DC Direct Real Estate products that invest in Private real estate funds may be limited by securities law private offering exemptions applicable to the underlying Private funds that preclude direct investment by participants.

“PLAIN ENGLISH” DISCLOSURES

If a DC Direct Real Estate product is offered as a stand-alone investment option for individual participants in a DC plan, plan participants should understand the liquidity constraints and other unique risks and considerations

Plan fiduciaries should consider whether their participants are capable of understanding and managing the risks of stand alone (core) Direct Real Estate options. Direct Real Estate products offered as a stand alone (or core) investment option should include more detailed, “plain English” disclosure to assist plan participants with understanding what to expect from such an investment and how the investment may affect their retirement accounts. Plan fiduciaries and product sponsors should consider offering participant investment education on the unique considerations for Direct Real Estate and consider asking participants to sign an acknowledgement form or provide an on-line acknowledgment with respect to illiquidity and other relevant risk disclosures. This risk may be greatly mitigated by only offering Direct Real Estate as a sleeve of a multi-asset fund.

INTEGRATION WITH PLAN MENU

If a DC Direct Real Estate product is offered to individual participants, plan fiduciaries could consider grouping the investment as part of a multi-product category (e.g., a real asset bundle) to reduce illiquidity risks that may arise from a particular product

Some DC plan investment menus are designed to allow plan participants to directly access any fund that is a component of a target date, multi-asset, multi-manager or other diversified investment option. This may limit the universe of Direct Real Estate products available to the investor because many do not (or cannot) accept direct investments from plan participants, or would otherwise not be appropriate as a stand alone option. A compromise may be to offer participants a direct option that is comprised of investments in multiple real estate products or a broader real asset bundle which may also include Listed Real Estate products.

“LEVEL” FEES

DC real estate products that utilize a fund-of-funds structure and where the investment fiduciary for the product is an affiliate of the underlying investment manager, should not have fees that are contingent on underlying investment allocations

ERISA rules prohibit conflicts of interest where the manager’s discretion to allocate to underlying investments can influence the overall fees charged to investors for DC products.

Fees can be “leveled” to avoid fiduciary conflicts through offsets or waivers of underlying fund fees.

ADDITIONAL RESOURCES

Collective Investment Funds - Comptrollers Handbook. Office of the Comptroller of the Currency.
(<http://www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/am-cif.pdf>)

Insurance Company Separate Accounts - NAIC
(http://www.naic.org/cipr_topics/topic_separate_accounts.htm)

Interval Funds - Securities Exchange Commission Fast Answers
(www.sec.gov/answers/mfinter.htm)

REIT Basics - NAREIT
(<https://www.reit.com/investing/reit-basics>)

Real Estate Investment Trusts (REITs) - Securities Exchange Commission Fast Answers
(www.sec.gov/answers/reits.htm)

DC RE PRODUCT COMPARISON

	Private Unregistered Investment Fund (LLC, LP,) Business Trust	Bank Collective Investment Trust	Insurance Company Separate Account	REIT*	Mutual Fund*	Interval Fund**
Investor Eligibility	Accredited investors	Certain tax favored ERISA and U.S. government Plans	Certain tax favored ERISA and U.S. Government Plans	Any (subject to state suitability)	Any	Any
Regulatory Oversight	Fund manager may be SEC registered	OCC or state banking regulator and ERISA	State insurance regulator and ERISA	SEC	SEC	SEC
Relative Regulatory filing, Operational and Administrative Obligations	Lower	Lower	Lower	Generally Higher	Higher	Generally Higher
Investment Guideline Flexibility	Flexible	Flexible	Flexible	Flexible	15% cap on illiquid assets, and certain income, asset and diversification restrictions	Certain income, asset and diversification restrictions if the fund is a 1099 re-porter
Tax Reporting	K-1 (tax flow through)	Tax Exempt	IRS Form 1099	IRS Form 1099	IRS Form 1099	K-1 or IRS Form 1099

* Listed Real Estate securities may be issued by REITs that are listed on the stock exchange. Public non-listed REITs are often used as a product structure for Direct Real Estate. Mutual funds are listed vehicles that may invest in Listed Real Estate securities.

** An interval fund is a fund that is registered under the Investment Company Act of 1940, like a mutual fund; but unlike a mutual fund, offers only periodic investment and redemption rights, accommodating less liquid assets.

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