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When Real Estate Investing Involves Securities: An Overview of Advisers Act Registration Obligations for Real Estate Fund Managers

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While many US real estate fund managers may not view themselves as being in the business of investing in securities (or advising on such investments), a significant portion of the industry has reluctantly found itself subject to a registration requirement or other compliance obligations as an investment adviser under the Investment Advisers Act of 1940, as amended (the Advisers Act). As discussed further below, proceeding without registration is entirely appropriate in the right circumstances and should be strongly considered, but taking this approach may reduce a manager's flexibility in marketing its business and managing its portfolios. As such, each manager's examination of its status and options is a bespoke exercise that requires careful consideration of its current and anticipated investments, its marketing strategy, its size, and the expectations and demands of its investor base. This analysis is particularly important for new and emerging managers, but can also be relevant for more established managers that have thus far remained unregistered (or that may wish to consider de-registration).

Impact of Dodd-Frank; Key Advisers Act Definitions

When the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) eliminated the so-called "fourteen-or-fewer clients" exemption in 2011, previously unregistered private fund managers of a certain size were confronted with a potential registration obligation under the Advisers Act.[1] For many managers that sponsor hedge, private equity, and debt funds, the analysis was and remains straightforward: their funds clearly invest in "securities" and, as such, they are required to register as an investment adviser with the US Securities and Exchange Commission (SEC).[2] For private real estate fund managers, however, the analysis is often more nuanced.

The Advisers Act defines "investment adviser" to include (with certain exceptions):

> 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.[3]

The definition naturally focuses on securities because the SEC is dedicated to overseeing the securities industry. It does not regulate real estate agents, private home sales, or direct purchases of commercial buildings. By way of example, Form ADV, the registration statement for investment advisers, lists real estate together with collectibles and commodities as being "non-securities" that are excluded from calculating an investment adviser's assets under management.[4] Real estate investing can frequently overlap with securities investing, however, so care should be taken before a real estate fund manager tries to simply opt out of the definition. The Advisers Act makes it unlawful for an investment adviser to conduct its business in the United States absent registration or a relevant exemption.[5]

The Advisers 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.[6]

Virtually identical definitions are provided under the Securities Act of 1933 (the Securities Act), the Investment Company Act of 1940 (the Investment Company Act), and the Securities Exchange Act of 1934 (the Exchange Act). For the most part, the SEC and courts have interpreted the definition under these various Acts consistently, although in some circumstances the definition of "security" has been held to be more expansive in the Investment Company Act context. Nevertheless, interpretations of the definition under each of these Acts can be informative as the SEC has cited to them when engaging in the analysis under the Advisers Act.[7]

Whether certain real estate-related assets constitute securities depends on the facts and circumstances in each case. There is no dispute that certain interests are not securities. For example, a fee simple interest in real estate is not a security.[8] Such interests stand at one end of the spectrum. Publicly traded mortgage-backed securities, passive interests in widely offered REITs or passive interests in any investment vehicle such as another real estate investment fund, however, are each securities under most circumstances. Between these two extremes are various other real-estate-related assets that must be analyzed based on the particular facts and circumstances.

Holding Companies and Joint Ventures

Many real estate funds hold real estate assets through holding vehicles or other structures formed by the fund or by the investment manager on behalf of the fund. Such a holding company may be a limited partnership or limited liability company, for example. The SEC has taken the position that limited partner interests in a limited partnership that holds and manages real estate assets generally are securities for purposes of the Securities Act and the Investment Company Act.[9] A general partner interest, however, is generally not considered a security unless, for example, the general partner does not participate in management or has any ability to do so (such that while labeled a "general partner" it may be viewed as "relying on the efforts of others" rather than its own).[10] If such a general partner also formed the underlying limited partnership as part of a fund formation process (as opposed to acquiring such interest on a secondary basis), this would also lend further support to the position that such a general partner interest is not a security. With respect to a limited liability company, the role of a managing member or manager could also be viewed as substantially analogous to that of a general partner for purposes of the foregoing analysis. Additionally, wholly-owned limited liability companies (or other wholly owned vehicles such as subsidiary REITs) are often formed for the purpose of holding one or more real estate assets. Generally speaking, if a fund forms an entity through which to hold an asset that is not a security, such formation should not constitute advising on an investment in securities.

A "joint venture" is also a common construct in the context of real estate investment. The term does not necessarily refer to any specific type of legal entity (a so-called joint venture could be formed as a limited partnership, a limited liability company, or even a corporation, for example), but rather is a descriptive term implying joint economic participation along with some notion of joint managerial responsibility. The SEC Staff and various courts have agreed that a joint venture need not be treated as a security, and the Staff also has accepted that position even in the case of a joint venturer having just a 25 percent stake, as well as in the case of a joint venture formed as a corporation (which issues shares of common stock that are more commonly known as securities).[11] As such, while the relevant facts and circumstances are critical, it is clear that real estate joint ventures can potentially be considered non-securities for purposes of the Advisers Act.[12]

Real Estate Debt

For real estate fund managers that focus in whole or in part on real estate-related debt, the question becomes whether the relevant debt instruments could be characterized as "investment contracts" or "notes" such that they could be viewed as being securities under the Advisers Act. The key analysis in considering whether an instrument is an investment contract arises from the *Howey* case.[13] Under *Howey*, an investment contract constitutes a security when there is: (1) an investment of money; (2) in a common enterprise; (3) where a person is led to expect profits; (4) solely from the efforts of the promoter or third party. Additionally, analysis of whether a debt instrument is a note that may be deemed to be a security for purposes of the Advisers Act might be informed by factors set forth in the *Reves* case under the Securities Act (for example, plan of distribution, an expected secondary market, etc.).[14]

"In the Business"

Separately, to fall within the definition of an investment adviser, a person must be "in the business" of providing advice with respect to investing in securities. The SEC Staff has said that it "considers a person to be 'in the business' of providing such investment advice if, among other things, the person provides specific investment advice on anything other than rare, isolated and non-periodic instances."[15] As such, a real estate fund manager that advises on investments in securities only occasionally, and does not hold itself out as providing advice on investing in securities, could potentially make the argument that they do not meet the definition of an investment adviser simply because they are not in the business of providing investment advice with respect to securities.

RAUM Thresholds; Interplay with Investment Company Act

Assuming for argument's sake that a real estate fund manager does fall within the investment adviser definition, that manager generally speaking would also have to have $100 million or more of "regulatory assets under management" (RAUM) to be required to register under the Advisers Act.[16] In making this determination, a manager must calculate the value of its securities portfolios. With one important exception, a fund or account is a "securities portfolio" only if at least 50 percent of its value is attributable to securities. The critical exception to that general rule is that for any "private fund" (that is, any fund that is not registered under the Investment Company Act in reliance on Section 3(c)(1) or Section 3(c)(7) thereof), the entire value of the fund is included for purposes of calculating RAUM, regardless of the mix of securities and non-securities held by the fund. While in-depth Investment Company Act analysis of real estate funds is outside the scope of this article, the intersection between the Advisers Act and the Investment Company Act can be very relevant to the Advisers Act analysis. For example, it would seem unlikely (although perhaps not impossible) that a real estate fund manager whose funds and/or co-investment vehicles all rely on Section 3(c)(5)(C) (the real estate exemption from registration under the Investment Company Act[17]) would have sufficient RAUM to be able to or be required to register under the Advisers Act. Conversely, a real estate fund manager whose funds and/or co-investment vehicles all rely on Section 3(c)(1) or Section 3(c)(7) and have an aggregate value of more than $100 million would seem more likely than not to have a registration obligation.[18] As such, the compliance approaches taken by a real estate fund manager with respect to its own registration status under the Advisers Act and that of its funds and/or co-investment vehicles under the Investment Company Act are intimately connected, and one should not be addressed without consideration of the other.

Market Practice and SEC Focus on Real Estate Fund Managers

It is interesting to note that Advisers Act registration is fairly commonplace among the largest real estate fund managers in the current market.[19] At least some of these managers likely registered even though they could take the position that they are not required to do so (or, by extension, even though the SEC could theoretically challenge their basis for registering[20]). Some of these managers may view Advisers Act registration as helpful in their marketing efforts and in the due diligence process conducted by potential investors. While Advisers Act registration does not imply any particular level of skill or training, it does involve an inherent degree of regulatory oversight that tends to be viewed in a positive light by prospective investors. Other managers may just desire the flexibility to be able to invest in any type of real estate assets, including real estate-related securities, without having to continually monitor and analyze their registration obligations. Conversely, a large unregistered real estate fund manager should be prepared to receive questions on the topic given the prevalence of Advisers Act registration among its peers (and the same would be true for a registered manager considering a de-registration). As noted previously, however, a no registration position for such a manager may be entirely legitimate and appropriate, and such an approach could be explained in detail to any interested parties.

And what about smaller or emerging real estate fund managers for whom a no-registration position is viable, including on a going forward basis, and to whom the legal and compliance costs and ongoing obligations for Advisers Act registration seem daunting? For these managers it may also make critical business sense to remain unregistered.[21] Advisers Act registration entails the preparation and filing of Form ADV, which calls for information regarding an adviser's ownership structure, business activities, investment strategies, fees, disciplinary history and conflicts of interest, among other items. Form ADV is publicly available and must be updated at least annually. Advisers Act registration also requires appointment of a chief compliance officer and development of various compliance policies and procedures.[22] The Advisers Act places certain restrictions on advertising and political contribution activity, as well as on arrangements for the custody of client assets, and requires that an adviser maintain certain books and records regarding its business. Significantly, an adviser registered under the Advisers Act is also subject to both routine and special examination by SEC Staff, which can be an operationally burdensome and intimidating exercise. A recent

SEC "sweep" examination targeting real estate advisers serves to highlight both the prevalence of Advisers Act registration among such managers, as well as perhaps the intention of the SEC to extend its regulatory reach further into the real estate sector.[23] Areas of particular interest for this SEC initiative have included expense allocations, the use of affiliates for services such as property management (and the related fees paid in connection therewith), and co-investment procedures.

Regardless of size, should a real estate fund manager decide not to register, it also should be mindful of the applicable Advisers Act analysis when crafting its disclosure in private placement memoranda and the provisions of its fund operating agreements (for example, clear investment limitations or deal structuring parameters that are helpful for its Advisers Act analysis could be considered, and extra caution should be taken with respect to any discussion of investing in securities).

While Advisers Act registration has become increasingly common for real estate fund managers of all sizes in recent years, those managers whose investment portfolios and strategies allow them to do so still have every right to take the position that, since they advise on investments in real estate and not securities, they are not required to register under the Advisers Act. With the Trump administration and new SEC leadership now at the helm, it also remains to be seen whether the SEC may take a more hands-off approach to real estate fund managers generally, including with respect to enforcement actions and the interpretation of registration obligations.[24]

Both emerging and larger fund managers who are uncertain about their Advisers Act status (or who believe they could tailor their business and product offerings so as to not be subject to a registration requirement) should consult with legal counsel regarding their particular situation. Thoughtful analysis to determine available options and an appropriate course of action is well worth the time and effort.

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NOTES

1 The "fourteen-or-fewer clients" exemption was widely available to fund managers in large part because each fund was generally deemed to be only one client, with no look-through to underlying investors. Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006). Though outside the scope of this article, it should be noted that, post-Dodd-Frank, private real estate fund managers, particularly those that engage in any interest-rate or currency hedging activities, need to also be mindful of their potential registration or notice filing obligations as a "commodity pool operator" and/or "commodity trading advisor" under the Commodity Exchange Act.

2 Much has been made recently of a potential overhaul of the Dodd-Frank Act, and a total repeal (or targeted resurrection of the "fourteen-or-fewer clients" exemption) would dramatically alter the registration landscape for many fund managers. Additionally, on June 8, 2017, the US House of Representatives passed the Financial CHOICE Act of 2017 (the CHOICE Act), which proposes to scale back or eliminate many of the post-crisis financial reforms promulgated by Dodd-Frank. Section 858 of the CHOICE Act calls for Section 203 of the Advisers Act to be amended by (a) providing that no investment adviser shall be subject to the registration requirements of the Advisers Act with respect to providing investment advice relating to a private equity fund, and (b) requiring that the SEC issue final rules to: (i) define the term "private equity fund" for these purposes, and (ii) require investment advisers to private equity funds to maintain such records and provide such reports as the SEC deems necessary. This proposed Advisers Act amendment has the potential to release a wide

universe of private fund managers from Advisers Act registration requirements, but the SEC's definition of "private equity fund" and the reporting and recordkeeping that will be required of such unregistered advisers will be critical to determining the true practical impact. Further, the prospects for the CHOICE Act to be passed by the US Senate and become law in its current form are uncertain at best. As such, while any progression of the CHOICE Act should be closely monitored, it would be premature at the time of this writing (July 2017) to rely on its implementation as part of any analysis of a private real estate fund manager's registration obligations under the Advisers Act.

3 Section 202(a)(11).

4 Form ADV: Instructions for Part 1A, Instruction to Item 5.F, p.9.

5 *See* Section 203(a) of the Advisers Act.

6 Section 202(a)(18) of the Advisers Act.

7 *See, e.g., Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers*, Investment Advisers Act Release No. 3222 (June 22, 2011), at notes 458 and 749 (citing *Reves*, *infra* at n.14, which related to whether an arrangement resulted in a security for purposes of the Securities Act, as the basis for investment advisers to determine whether a commercial lender has issued a security for purposes of the Advisers Act).

8 *See, e.g.,* SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (*Howey*) (under the Securities Act: noting certain exceptions to that rule); Arizona Property Investors, Ltd., SEC Staff No-Action Letter (Aug. 9, 1979) (*Arizona Property*) (under the Investment Company Act: "Generally, we would not consider fee interests in real estate to be securities."); Kenneth H. Flood, SEC Staff No-Action Letter (Mar. 2, 1984) (under the Advisers Act: "A complete fee interest in real estate in itself would not be a security.").

9 *See* Securities Act Release No. 4877 (Aug. 8, 1967). The general rule that limited partnership interests are securities is not absolute, however. *See* Steinhardt Group Inc. v. Citicorp, 126 F.3d 144 (3d Cir. 1997) (in which the Third Circuit held that a limited partnership interest was not a security for purposes of the Securities Act where the limited partner held a 98 percent interest as well as various approval and control rights).

10 *See, e.g.,* Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981), *cert. denied*, 454 U.S. 897 (1981) (*Williamson*) (under the Securities Act and the Exchange Act). *See also* Coldwell Banker Commercial Group, Inc., SEC Staff No-Action Letter (Jan. 21, 1982) (*Coldwell Banker*) (under the Advisers Act). The analysis is based on the facts and circumstances and driven by the premise that a controlling interest, involving active and extensive participation and management, negates the existence of a security in the context of real estate investment.

11 *See, e.g., Williamson*; Gordon v. Terry, 684 F.2d 736 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983) (concerning joint venture interests in undivided interests in real estate, under the Securities Act) and New World Associates, SEC Staff No-Action Letter (Aug. 9, 1985) (taking a no-action position if an entity held over 40 percent of its assets in joint ventures without registering under the Investment Company Act).

12 Similarly, investments in "club deals" would need to be considered based on the facts and circumstances (including managerial responsibilities of each party), but also have the potential to be considered non-securities investments with respect to one or more of the parties.

13 *See, e.g., Arizona Property* ("investment contracts that refer to fee interests in real estate, such as orange groves, are securities"), citing *Howey*.

14 *See* Reves v. Ernst & Young, 494 U.S. 56 (1990).

15 Independent Drug Wholesalers Group, Inc., SEC Staff No-Action Letter (Apr. 16, 1992) (declining to take no-action position with respect to scheduled, periodic provision of investment advice).

16 Note however that, for New York-based investment advisers, the generally applicable RAUM threshold is $25 million.

17 Section 3(c)(5)(C) excludes from the definition of "investment company" under the Investment

Company Act any person that is primarily engaged in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate."

18 Note however that a manager solely of private funds with less than $150 million of RAUM is exempt from full registration but is required to file an abbreviated Form ADV as an exempt reporting adviser.

19 *See* "Private Equity Real Estate Top 50—2016 Edition of Who is Registered", available at: *http://www.compliancebuilding.com/2016/05/04/private-equity-real-estate-top-50-2015-edition-of-who-is-registered-2/*. Note that the PERE list referenced here focuses only on commingled closed-end real estate funds, and excludes core and core-plus funds. Managers of funds within the "core" spectrum (which are often structured as open-end products), may be better positioned to take a no-registration approach under the Advisers Act as such funds tend to have a narrower mandate to buy and hold hard real estate assets (as compared to opportunistic funds, for example, which generally speaking have broader discretion to invest in a wide range of real estate-related assets, some portion of which could be considered securities). The fact that a fund is open-end or closed end, however, should not in and of itself have an impact on the Advisers Act analysis.

20 Any such action by the SEC would obviously signal a significant pullback of the SEC's regulatory reach. Further, it should be noted that even if Advisers Act registration is determined to not be required for a particular manager, state investment adviser registration obligations could still apply.

21 Note that unregistered investment advisers are still subject to the anti-fraud provisions of the Advisers Act.

22 Some such policies, such as the requirement for a code of ethics and procedures designed to prevent insider trading, can seem wholly inapposite to the business of a traditional real estate fund manager (as compared to a hedge fund investing in publicly traded equities, for example).

23 *See* Marc Wyatt, acting director, OCIE, "Private Equity: A Look Back and a Glimpse Ahead" (May 13, 2015), available at *www.sec.gov/news/speech/privateequity-look-back-and-glimpse-ahead.html.*

24 *See also* discussion of the CHOICE Act in n.2, *supra.*