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Regulating real estate funds

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Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act with the goal of changing the regulation of financial services. Dodd-Frank's changes to the Investment Advisers Act of 1940 were not surprising to hedge fund managers, but the changes may be surprising — and unwelcome — to managers of privately held real estate funds, many of whom could be pulled into the regulatory fold because of changes to the Advisers Act.

Generally speaking, a fund manager is an investment adviser if the manager is paid to manage a fund that invests in securities. This applies to hedge funds, to private equity funds — and to real estate funds.

For any privately held fund, typically either the manager of, or an adviser to, the fund provides advice on the investments to be made by the fund. If the fund's investments are securities, the manager or other adviser to the fund usually meets the definition of investment adviser that is provided in the Advisers Act.

An investment adviser is “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.”

The definition of security in section 2(1) of the Securities Act includes the variety of equity and debt instruments that are commonly understood to be securities, as well as other forms of investments that are less commonly referenced, such as “investment contracts.”

Courts and the Securities and Exchange Commission have provided guidance when

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If an exemption from registration as an investment adviser is available under the Advisers Act, it could be limited to managers or advisers of particular types of structures of real estate funds.

it is unclear if an instrument, arrangement or product is a security.

For example, with respect to real estate investments, according to the SEC staff, Tenant-in-Common (TIC) interests may be securities. In a no-action letter issued by the SEC to Luce Forward, the staff of the SEC declined to grant no-action relief and confirm that the TIC interests were not securities, based on the facts presented in the request to the SEC. There are, of course, a variety of real estate investment structures and arrangements that do not involve securities.

Before Dodd-Frank, regardless of whether a real estate fund manager was advising its fund on the purchase and sale of securities, the “private adviser exemption” usually provided the manager with an exemption from registration and most other requirements of the Advisers Act.

Section 203(b)(3) of the Advisers Act provided that an investment adviser who, during the course of the preceding 12 months, had fewer than 15 clients and who did not hold itself out as an adviser or act as an adviser to a registered investment company was exempt from registration (and most other requirements applicable to registered investment advisers, such as limits on performance fees). Under the Advisers Act, a fund is a single client if certain standards are met, and previously, a fund manager that did not hold itself out as an adviser could count the number of funds it advised without regard to the amount of assets under management and could advise up to 14 funds without being subject to

registration as an investment adviser.

Dodd-Frank repealed the broad private adviser exemption and replaced it with three narrow exemptions: for foreign private advisers, venture capital fund advisers and private fund advisers. Of these, only the private fund adviser exemption could be useful to U.S.-based real estate fund managers.

Most interestingly, the exemption for private fund advisers might be unavailable to real estate fund managers.

Dodd-Frank defined a “private fund” as an issuer that would be an investment company “but for section 3(c)(1) or 3(c)(7)” of the Investment Company Act, the most commonly used exemptions for privately held securities investment funds. Both sections exempt issuers that are not making public offerings of their securities: Section 3(c)(1) exempts issuers whose securities are beneficially owned by less than 100 persons, while section 3(c)(7) exempts issuers whose securities are sold to “qualified purchasers.”

If a fund is exempt from status as an investment company only because of section 3(c)(1) or 3(c)(7), for example, it is the sole exemption in the Investment Company Act upon which it can rely, then it is a private fund under the Advisers Act, as amended by Dodd-Frank.

As real estate fund managers and their counsel are aware, to the extent a fund invests greater than 40 percent of its assets in securities and it otherwise would be an investment company, the Investment Company Act provides additional exemptions.

For example, section 3(c)(5) of the Investment Company Act exempts: “any person who is not engaged in the business of issuing redeemable securities ... and who is primarily engaged in ... purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.”

To avoid classification as an investment company, real estate funds might look to the exemption found in section 3(c)(5) of the Investment Company Act. However,

according to the literal language of the Dodd-Frank, if a fund is able to rely on another exemption found in the Investment Company Act, it apparently is excluded from the definition of “private fund.”

This suggests that managers and other advisers to real estate funds are unable to rely upon the exemption available to private fund managers. Consequently, small real estate fund managers will be subjected to greater regulatory burdens under the Advisers Act than small hedge fund managers, as a result of the changes made by Dodd-Frank.

The SEC, charged with drafting hundreds of implementing regulations, has

not finalized changes to the Advisers Act’s regulations, but the final rules and related guidance that it issues in the near term should clarify what is required for private real estate fund managers and advisers to remain in compliance with the Advisers Act, as amended by Dodd-Frank.

If an exemption from registration as an investment adviser is available under the Advisers Act, it could be limited to managers or advisers of particular types of structures of real estate funds. If an exemption from registration as an investment adviser is not available under the Advisers Act, depending on the amount of “assets under management,” (which will be determined differently than in the past),

a manager advising its fund about securities will be required to register with the SEC or subject to registration with one or more states. If a manager is subject to state registration, it may be able to rely on a de minimis exemption, available when an investment adviser advises a limited number of clients in the state.

Going forward, real estate fund sponsors, managers and advisers are going to spend additional time and resources determining whether they remain in compliance with the Advisers Act. Those that advise their funds on the purchase, sale or holding of securities will have to carefully evaluate whether to register as an investment adviser.