

Real Estate Fund Structuring: The Impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act

The Impact of Title IV of the Dodd-Frank Act on Real Estate Investment Adviser Registration

The Advisers Act requires many “investment advisers” to register with the Securities and Exchange Commission unless an exemption from registration applies. At present, many real estate investment advisers rely upon the registration exemption provided by Section 203(b)(3) of the Advisers Act. Section 203(b)(3) currently exempts from registration certain investment advisers having fewer than 15 clients in any 12-month period if certain conditions are met. In applying the numerical limit in Section 203(b)(3), the SEC generally permits investment advisers to count as a single “client” any real estate fund they advise, but the SEC does not require such funds to count the individual investors as separate clients. Accordingly, private fund managers have been able to rely upon the private advisers exemption in Section 203(b)(3) and advise a substantial number of separate funds (not more than 14 in any 12-month period) without becoming subject to SEC registration.

The Dodd-Frank Wall Street Reform and Consumer Protection Act strikes Section 203(b)(3) in its entirety and replaces it with a provision that provides that the Advisers Act will not apply to “any investment adviser that is a foreign private adviser.”¹ However, US investment advisers (nonforeign) will no longer be able to rely upon Section 203(b)(3). As a result, most real estate investment advisers falling within the definition of “investment adviser” under the Advisers Act may become subject to the registration requirements under the Advisers Act, unless otherwise exempt.

The Dodd-Frank Act generally raises the floor for investment adviser registration under the Advisers Act to \$100 million in assets under management, though there are considerable nuances in the Dodd-Frank Act that could result in a different floor in certain cases. As a result, most real estate investment advisers with assets under management of less than \$100 million will neither be required nor permitted to register with the SEC. However, most real estate investment advisers with assets under management above \$100 million would potentially be required to register under the Advisers Act, unless otherwise exempt.

To the extent an investment adviser must register or chooses to register under the Advisers Act after the Dodd-



Frank Act, it will be subject to additional requirements under the Advisers Act. For example, registered investment advisers are required to

- file the Form ADV, which includes a narrative description of the activities of the investment adviser and its investment strategy;
- comply with various record-keeping obligations, including advertising, trading, and operational document retention obligations;
- submit to in-person examinations by SEC personnel;
- implement a comprehensive compliance program and designate a chief compliance officer;
- establish and maintain a written code of ethics setting a standard of conduct reflecting fiduciary obligations;
- comply with client cash and securities custody procedures.

In addition, under the Dodd-Frank Act, the SEC could require registered investment advisers to maintain records, and to provide reports to the SEC regarding private funds managed by the investment adviser.²

Structuring Operations So That a Real Estate Investment Adviser Is Not an “Investment Adviser”

Real estate investment advisers that are required to register may desire to structure their operations so that they are not investment advisers within the meaning of the Advisers Act, which would allow investment advisers to avoid registration under the Advisers Act and likely under state law as well. The Advisers Act defines an “investment adviser” generally to include any person (including a natural person or an entity) who for compensation is engaged in the business of providing advice to others or issuing reports or analyses regarding securities.

To the extent that a real estate adviser advises about “securities,” it will usually be considered in the business of providing



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1. Dodd-Frank Act, Section 403.

2. Dodd-Frank Act, Section 404.

investment advice and therefore an “investment adviser” within the meaning of the Advisers Act. Real estate fund advisers can reduce the risk that they will be considered investment advisers by limiting any advice about securities to one-off advice and explicitly stating orally and in writing to investors that the real estate adviser is neither holding itself out nor representing that it is an investment adviser.

Many types of real estate investments have a securities aspect to them. Types of real estate investments that could be deemed securities include passive entity investments, mortgage-backed securities, asset-backed securities, mortgage participation interests, industrial development bonds, certain types of notes, fractional undivided interests in real estate by which a promoter or nominee assumes the responsibility of physical management of property and distribution of profits to co-owners, certain types of condominiums and real estate development, and certain types of leases and investment contracts. The ultimate determination of whether a real estate investment is a security involves complex, fact-specific legal considerations. Counsel should be consulted when making such a determination.

Structuring Operations So That a Real Estate Investment Adviser Does Not Advise “Private Funds”

Assuming that a real estate investment adviser is required to register as an investment adviser, it may be able to obtain limited relief from certain requirements under the Dodd-Frank Act by structuring its exempt funds so that they are not “private funds” (funds that rely upon Section 3(c)(1)³ or Section 3(c)(7)⁴ exemptions under the Investment Company Act of 1940). Under the Dodd-Frank Act, these requirements include record-keeping and reporting requirements in respect of private funds, future regulations regarding private funds, and counting investors in private funds for purposes of determining whether a foreign investment is in fact a “foreign private adviser” exempt under revised Section 203(b)(3).

As a result, real estate investment advisers that are investment advisers within the meaning of the Advisers Act may therefore seek to structure their real estate funds so that they rely upon Investment Company Act exemptions other than Section 3(c)(1) or Section 3(c)(7).⁵ In particular, these real estate investment advisers will want to consider exemptions under Section 3(a)(1),⁶ Section 3(b)(1),⁷ Section 3(c)(5)(C),⁸ and Section 3(c)(6)⁹ of the Investment Company Act. The ex-

act requirements of these exemptions are beyond the scope of this article, but each exemption involves a complex securities analysis that will require counsel. Nonetheless, they may also provide real estate investment advisers¹⁰ with several benefits.

3. Section 3(c)(1) generally exempts from the definition of “investment company” “any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.” See 15 U.S.C. § 80a-3(c)(1).

4. Section 3(c)(7) generally exempts “any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities.” See 15 U.S.C. § 80a-2(a)(51); 17 C.F.R. § 270.2a-51-1.

5. Note that real estate funds that were formed as Section 3(c)(1) or Section 3(c)(7) exempt investment companies, not only new funds, may be able to structure their operations so that they are exempt under other Investment Company Act exemptions.

6. The term “investment company” means under Section 3(a)(1) any issuer that “(A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; (B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or (C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percentum of the value of such issuer’s total assets (exclusive of Government securities and cash items) on an unconsolidated basis.” “Investment securities” include all securities except government securities, securities issued by employees’ securities companies, and securities issued by majority-owned subsidiaries of the owner that are not investment companies and are not relying on the exception from the definition of investment company in paragraph (1) or (7) of subsection (c).

7. Section 3(b)(1) provides that “any issuer primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities” is not an “investment company.”

8. In order to rely upon Section 3(c)(5)(C), the issuer must not issue face amount certificates of the installment type, securities redeemable at the option of the holder, or periodic payment plan certificates. The SEC has taken the position that in order to satisfy the “primarily engaged” requirement of Section 3(c)(5)(C), an issuer must invest at least 55% of its assets in mortgages and other liens on and interests in real estate (“Qualifying Interests”). An additional 25% of the issuer’s assets must be in real estate-related assets, although this percentage may be reduced to the extent that more than 55% of the issuer’s assets are invested in Qualifying Interests. Twenty percent of the issuer’s assets may be in unrestricted miscellaneous assets.

9. Section 3(c)(6) exempts from the definition of an investment company any company primarily engaged in, directly or through majority-owned subsidiaries, one or more of the businesses described in Section 3(c)(3), Section 3(c)(4), or Section 3(c)(5) or in one or more of such businesses (from which not less than 25% of such company’s gross income during its fiscal year was derived) together with an additional business or businesses other than investing, reinvesting, owning, holding, or trading in securities. Section 3(c)(3) generally relates to banks and savings and loans, while Section 3(c)(4) generally relates to any person substantially all of whose business is confined to consumer financing agencies.

10. As a matter of policy, certain requirements under the Dodd-Frank Act should not apply to real estate funds utilizing Section 3(a)(1), Section 3(b)(1), Section 3(c)(5)(C), and Section 3(c)(6) exemptions, as these funds do not present “systemic risk” concerns. Systemic risk occurs, generally speaking, when distress at the fund level poses a threat to the financial stability of the United States. Unlike highly leveraged hedge funds that trade highly liquid assets, most real estate funds do not pose systemic risk as they use considerably lower leverage and invest over a longer time horizon.

Benefits of Advising Section 3(a)(1), Section 3(b)(1), Section 3(c)(5)(C), and Section 3(c)(6) Funds

Record-Keeping and Reporting Requirements Under the Dodd-Frank Act

By virtue of Section 404 of the Dodd-Frank Act, the SEC may require any registered investment adviser to be subject to record-keeping and reporting requirements in respect of private funds. As the definition of “private funds” under Section 402 of the Dodd-Frank Act does not include funds exempt under Section 3(a)(1), Section 3(b)(1), Section 3(c)(5)(C), or Section 3(c)(6), real estate investment advisers that advise only exempt funds other than private funds should not be subject to such record-keeping and reporting requirements, although many real estate investment advisers would continue to be subject to the record-keeping and reporting requirements specified in Section 204 and the rules promulgated thereunder.

Future Regulation on the Horizon

The Dodd-Frank Act requires the comptroller general of the United States to conduct a study of the feasibility of forming a self-regulatory organization (SRO) to oversee private funds.¹¹ In addition, the Dodd-Frank Act requires the comptroller general to conduct a study of the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds.¹² As a result, it is likely that if there is further regulation of private funds, real estate investment advisers that advise exempt funds other than private funds will not be subject to such SRO oversight and increased suitability thresholds.

Foreign Private Advisers

Foreign real estate investment advisers may seek to rely upon the revised Section 203(b)(3) exemption under the Advisers Act for foreign private advisers, as defined in Section 202(a)(30) thereof. The term “foreign private adviser” means any investment adviser who, among other things, has, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser.

Under Section 202(a)(30) of the Advisers Act, an investment adviser will not be considered a foreign private adviser if it advises a total of 15 or more clients and US investors who invest in private funds advised by the investment adviser (even if the investment adviser advises fewer than 15 funds). Note that if a real estate investment adviser advises fewer than 15 exempt funds other than private funds, the requirement of counting investors in Section 202(a)(30)(B) likely would not apply because Section 202(a)(30)(B) requires the counting of investors in only private funds. Thus, relying on Investment Company Act exemptions other than 3(c)(1) or 3(c)(7) could make it easier for a foreign investment adviser to fit within the foreign private adviser exemption under the Advisers Act.

Volcker Rule

One last issue is that regardless of whether an investment adviser is an “investment adviser” within the meaning of the Advisers Act, the new Volcker Rule provides, subject to certain limited exemptions, that “banking entities” may not acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.¹³ The Volcker Rule generally defines both “hedge funds” and “private equity funds” to include any issuers that rely on the exclusion from the definition of investment company under sections 3(c)(1) or 3(c)(7) of the Investment Company Act or “any similar funds” as determined by the SEC, Commodity Futures Trading Commission (CFTC) or appropriate federal banking agencies.¹⁴

Currently, these agencies are considering promulgating rules so that these types of funds would become subject to the Volcker Rule. If these agencies limit their discretion and promulgate rules that exclude exempt funds other than Section 3(c)(1) and Section 3(c)(7) exempt funds from the scope of the Volcker Rule, real estate investment advisers would find it particularly advantageous to advise exempt funds other than Section 3(c)(1) and Section 3(c)(7) exempt funds. ■

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11. Dodd-Frank Act, Section 416.

12. Dodd-Frank Act, Section 415.

13. 12 U.S.C. § 1851(a)(1)(B).

14. 12 U.S.C. § 1851(h)(2).