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Considerations in Complying with the Investment Advisers Act

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A sponsor that intends to raise capital from third-party investors for investment in real estate or real estate-related assets should consider whether the general partner, managing member or outside adviser to the vehicle that will be formed to undertake the investment will be required to register as an investment adviser under, and comply with the other requirements of, the Investment Advisers Act of 1940.[1] While it is generally accepted that direct investment by an investment vehicle in "bricks and mortar" assets, such as a fee or leasehold ownership interest in real estate, would not trigger the application of the Advisers Act, further inquiry will be warranted where some or all of the investments made by entities managed by the general partner or managing member are arguably "securities" under the act.

Overview of the Act

The Securities and Exchange Commission (SEC) regulates investment advisers pursuant to the terms of the Advisers Act, which defines an investment adviser as any person or firm who satisfies the following three elements: (1) the adviser engages in the business of advising others, (2) in consideration for providing such advice, the adviser receives compensation, and (3) the advice concerns the value of, or the advisability of purchasing or investing in, securities.[2]

Unless an exemption is available,[3] an investment adviser with regulatory aggregate assets under management (RAUM) of $100 million or more (other than a family office) must register with the SEC[4] and comply with the SEC's extensive record-keeping and reporting requirements[5] and will be subject to SEC examination.[6] These include submitting (and updating) Form ADV, maintaining certain books and records, complying with detailed custody rules, adopting certain compliance policies and procedures such as designating a chief compliance officer, and enacting (and providing employee training for), a code of ethics. The act also limits a registered investment adviser's right to receive compensation tied to performance.[7] All investment advisers, even if exempt from registration, have a non-waivable fiduciary duty to their clients under the act.[8]

Providing Advice

The threshold for satisfaction of the first two tests for determining whether an adviser to one or more real estate investment vehicles is an investment adviser under the Advisers Act—that the adviser be in the business of providing advice in exchange for consideration —is very low and will typically be satisfied. The adviser will be providing advice to the investment vehicle regarding the value of, or the advisability of purchasing or investing in, the investment, and will be compensated for its role in providing that advice. For purposes of the act, compensation is defined broadly to include any economic benefit. This would include any fees (including management or similar fees payable to the sponsor or its affiliates through separate agreements) or preferred or promoted return to the sponsor that entitles it to economics in excess of its pro-rata share of distributions to investors in the investment vehicle.[9]

Is the Investment a Security?

Central to the determination of whether a person is an investment adviser for purposes of the Advisers Act is whether he or she provides advice in respect to "securities" as determined by the act. The act defines a "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.[10]

Central to the determination of whether a person is an investment adviser for purposes of the Advisers Act is whether it provides advice in respect to "securities" as determined pursuant to the act.

While this definition is substantially the same as the definitions of "securities" under the Securities Act of 1933[11] (the 1933 Act) and the Securities Exchange Act of 1934[12] (the 1934 Act), the SEC has not issued any formal guidance as to whether it interprets the Advisers Act's definition in a manner similar to the definitions of "security" under the 1933 and 1934 Acts. Nevertheless, case law and SEC rulings establishing what constitutes a security for purposes of the 1933 and 1934 Acts are relevant to interpreting the Advisers Act because it is highly likely that a "security" under the 1933 and 1934 Acts will also be deemed to be a "security" under the Advisers Act.

In *SEC v. W.J. Howey*,[13] the Supreme Court held that an investment contract is a "security" for purposes of the 1933 Act where (1) there was

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an investment of money in a common enterprise with others, (2) there was an expectation of profits from the investment and (3) the outcome of the investment depends solely on the efforts of others. In the real estate context, each investment held by an investment vehicle must be analyzed in light of *Howey* and subsequent authority in order to determine whether it is a security.

When the vehicle's investment is in an entity which itself holds real estate, as opposed to direct ownership by the vehicle of real property, the level of management and control over the entity by the investment vehicle must be considered. For example, shares in a controlled special purpose acquisition vehicle are likely not securities, while shares in a publicly traded real estate investment trust (REIT) or passive limited partnership interests are securities. General partnership interests (or equivalent managing member interests in a limited liability company), ordinarily are not considered to be securities under the federal securities laws, since general partners or managing members control significant decisions of the enterprise and do not ordinarily rely on the efforts of promoters or third parties.

However, if there are multiple general partners or managing members and if, under the partnership agreement of the partnership or the operating agreement of the limited liability company, one of the general partners or managing members has only a limited role in participating in partnership or company decisions, the fact that he is denominated a general partner or managing member may not prevent his interest from being deemed a security.

For example, the U.S. Court of Appeals for the Fifth Circuit has found that a general partnership interest could be an investment contract, and thus a security if the investor established that: (1) an agreement among the parties leaves so little power in the hands of the investor that the arrangement in fact distributes power as would a limited partnership; (2) the investor is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he or she cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers; or (3) the investor is so inexperienced and unknowledgeable in business affairs that the investor is incapable of intelligently exercising managerial powers.[14]

On the other hand, the U.S. Court of Appeals for the Third Circuit has held that a limited partnership interest was not a security where the limited partner had extensive approval and proposal rights and owned a 98.79 percent interest in the limited partnership.[15]

Given that a "note" or other "evidence of indebtedness" is listed in the definition of security under the Advisers Act, it is also appropriate to consider whether a person or entity is an investment adviser if it provides advice to an investment vehicle that invests in mortgages or other real estate related debt. In *Reves v. Ernst & Young*,[16] the U.S. Supreme Court established that a note is not necessarily a "security" for purposes of the 1933 and 1934 Acts, notwithstanding that the word "note" is listed in the definition of "security" under the 1933 and 1934 Acts, and it is generally accepted that for purposes of the 1933 and 1934 Acts, a mortgage loan is not considered a security.

However, the SEC has on numerous occasions stated that a note evidencing a commercial loan which would not be deemed to be a "security" for purposes of the 1933 and 1934 Acts is a "security" under the Investment Company Act of 1940 (the 1940 Act).[17] The SEC has not issued any formal guidance as to whether it would take a similar position with respect to the Advisers Act. One factor that may bear on whether a note or other evidence of indebtedness is a security is the extent to which such instruments can, or in fact will, be traded.

If, in light of the nature of the assets owned by an investment vehicle, the general partner or manager concludes that registration as an investment adviser may be required, an attorney with expertise in the Advisers Act should be consulted.

RAUM

In order to determine whether the adviser has RAUM of $100 million or more and must therefore register with the SEC, the adviser must take into account the value of "securities portfolios" over which it provides continuous and regular supervisory or management services.[18] An account or entity is a "securities portfolio" only if at least 50 percent of its value is attributable to securities, in which case the entire value of that account or entity (including the portion attributable to assets which are not securities) is included in determining the value of all "securities portfolios" managed by the adviser.

If less than 50 percent of the account's or entity's value is attributable to securities, then the account/entity is not considered by the Advisers Act to be a "securities portfolio," regardless of the size of its securities holdings, and none of its assets are counted when determining the amount of RAUM of the adviser. Note that where the account or entity is an issuer that is a "private fund"—i.e., an issuer that is excluded from the definition of "investment company" under the 1940 Act because it is relying on the exemption provided under Section 3(c)(1) of the 1940 Act (applying to funds privately offered to not more than 100 security holders) or Section 3(c)(7) of the 1940 Act (applying to funds privately offered to "qualified purchasers")—the entire value of the issuer is considered for purposes of determining RAUM without regard to the nature of its investments.

However, an issuer that is exempt as an investment company under the 1940 Act under Section 3(c)(5)(C) of that act (the real estate exemption) will not be treated as a private fund and it is therefore necessary to analyze its assets to determine whether it constitutes a "securities portfolio."[19] The real estate exemption provides in relevant part for an exclusion from the definition of investment company for any issuer that is "primarily engaged in…purchasing or otherwise acquiring mortgages and other liens on and interests in real estate."

The SEC staff takes the position that an issuer may not rely on the exclusion provided by Section 3(c)(5)(C) unless at least 55 percent of its assets consist of direct ownership interests in real estate mortgages and "other liens on and interests in real estate" (called "qualifying interests") and the remaining 45 percent of its assets consist primarily of real estate-type interests such as interests in companies that invest in mortgages or real estate).[20]

If, in light of the nature of the assets owned by an investment vehicle, the general partner or manager concludes that registration as an investment adviser may be required, an attorney with expertise in the Advisers Act should be consulted. Such an attorney will be able to assist in analyzing whether the assets under management include securities and whether the sponsor is an investment adviser and, if so, whether registration with the SEC will be required. Such an attorney can also help the sponsor in managing its compliance with the Advisers Act.

1. 15 U.S.C. §80b-1 – 80b-21. This article is intended to apply to domestic advisers. Special rules, which are beyond the purview of this article, apply to foreign advisers.
2. 15 U.S.C. §80b-2(a)(11).
3. Prior to its elimination pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2008, many investment advisers were able to rely on the so-called "private adviser exemption," which afforded an exemption from registration for advisers with less than 15 clients.
4. 15 U.S.C. §§80b-3 & 3a. An investment adviser with regulatory assets under management between $25 million to $100 million would in most cases be required to register only at the state level. A state-by-state analysis must be undertaken to determine if an exemption from registration is available in that state.
5. Reg §275. 204-2.
6. 15 U.S.C. §80b-4.
7. 15 U.S.C. §80b-5.
8. *S.E.C. v. Capital Gains Research Bureau*, 375 U.S. 180 (1963).
9. SEC Release No. IA-1092.
10. 15 U.S.C. §80b-2(a)(18).
11. 15 U.S.C. §77a et seq.
12. 15 U.S.C. §78a et seq.
13. *SEC v. W.J. Howey,* 328 U.S. 293 (1946).
14. *Williamson v. Tucker*, 645 F.2d 404 (5th Cir.), cert denied, 454 U.S. 897 (1981).
15. *Steinhardt Group Inc. v. Citicorp*, 126 F.3d 144 (3d Cir. 1997).
16. 494 U.S. 56 (1990).
17. See Investment Company Determination under the 1940 Act, Robert H. Rosenblum, at 56.
18. Form ADV: Instructions for Part IA.
19. An adviser solely to private funds (including, for this purpose, funds relying on §§3(c)(1), 3(c)(7) and 3(c)(5)(C) of the 1940 Act) with assets of less than $150 million is exempt from registration as an investment adviser although it must file a shortened Form ADV with the SEC as an exempt reporting adviser.
20. Capital Trust Inc., SEC No-Action Letter (Feb. 3, 2009).