FSPM
Fragner Seifert Pace & Mintz

Real Estate Fund Sponsors Are Investment Advisers

During my 25-year legal career, I have worked with numerous real estate fund sponsors, both as a principal and as outside counsel, and have had many conversations regarding the application of federal and state securities laws, particularly the Investment Advisers Act of 1940 (the "Advisers Act") to the real estate fund business. In these conversations, many real estate fund sponsors have expressed the view that real estate is fundamentally different from other alternative investments and that they should not be subject to the same regulations as other fund sponsors.

Real estate fund sponsors generally grew up in the world of real estate development and are immersed in the minutiae of acquiring, developing, and operating real property. Real estate sponsors are generally hands-on operators rather than passive investors and have very little in common with the traders and investment bankers who operate hedge and private equity funds. Not surprisingly, real estate fund sponsors are skeptical that they are investment advisers subject to state and federal regulation simply because they have raised a fund to finance their real estate projects.

While I agree that real estate fund sponsors are generally distinct in terms of background, culture, and personality, it does not follow that they are exempt from the securities acts, including the Advisers Act. As I have counseled, both the plain text of the Advisers Act and the policy underlying the securities laws are unequivocal that real estate fund sponsors are investment advisers, and subject to state and federal regulation.

Investment Adviser Defined and Regulated

An "investment adviser" is defined in Section 202(a)(11) of the Advisers Act (15 U.S.C. Section 80b-2(a)(11))) as 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, purchase, or selling **securities**" (emphasis added). The Advisers Act defines "security" broadly to include 17 different types of instruments, including "investment contracts" (which is itself a catch-all, as described below), and "any interest or instrument commonly known as a 'security'". (See Section 202(a)(18), 15.U.S.C. Section 80b-2(a)(18)).

Section 203 of the Advisers Act (15 U.S.C. Section 80b-1) states that it is unlawful for any unregistered investment adviser not regulated by a state to make use of the mails or any means or instrumentality of interstate commerce in connection with his or its business an investment adviser unless one of the narrow exemptions in Section 203(b) apply.

Investment advisers with less than $25 million of assets under management that do not advise a registered investment company are regulated by the state in which they maintain their principal office and place of business (Section 203A, 15 U.S.C. Section 80b-3a). Investment advisers with between $25

million and $100 million of assets under management are generally regulated by the state in which they maintain their principal office and place of business unless they advise a registered investment company or a business development company or are not subject to examination as an investment adviser by the applicable state authority. Such medium sized advisers may voluntarily register with the SEC, however, to avoid burdensome multiple state registrations. Investment advisers with over $100 million in assets under management must register with the SEC.

"Assets under management" is calculated based on the value of the securities portfolios for which an investment adviser provides continuous and regular supervisory or management services. (Section 203A(a)(3), 15 U.S.C. Section 80b-3a(a)(3)). An account is a securities portfolio if at least 50% of the total value of the account consists of securities and all the assets of a "private fund", including any uncalled capital commitments, are a securities portfolio regardless of the nature of such assets. A "private fund" is any issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) thereof. (See Section 20(a)(29), 15.US.C. Section 80b-2(a)(29)).

Passive Interests in Real Estate are Securities

The threshold question for determining whether the sponsor of a real estate fund is an investment adviser is whether the real estate interests the sponsored fund invests in are "securities". If such interests are securities, the fund will constitute a securities portfolio if more than 50% of the value of the fund consists of securities or if the fund is a private fund, and the general partner and investment adviser to the fund will be "investment advisers" if they provide "continuous and regular supervisory or management services" to the fund.

As noted above, the Advisers Act defines "security" to include, among other things, an "investment contract". The Supreme Court in the seminal case of SEC v. Howey Co., 328 U.S. 93, 298-99 (1946) defined an "investment contract" as a "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."

In evaluating whether a sponsored fund's real estate investment constitutes a security, the operative question is whether the sponsored fund's interest constitutes a passive investment in which the fund expects to realize profits solely from the efforts of a third party, or an investment in which the fund expects to realize profits from its own efforts.

Most real estate fund sponsors are comprised of an operating platform, comprised of one or more companies that contain the physical and intellectual assets (e.g., employees) that evaluate and operate real estate assets on behalf of the sponsored funds, and one or more special purpose entities that act as the general partner of the sponsored real estate funds. Some real estate fund operators further subdivide the operating platform based on function, for example, by separating the investment function from property management, leasing and/or development functions. Because of this division, the general partner of the real estate fund does not have the capability to independently identify, evaluate, acquire

and operate real estate assets on behalf of the sponsored fund. Rather, the general partner delegates these functions to the affiliated operating platform, which acts as the investment advisor or manager to the fund and generally provides ancillary services (property management, leasing, development, and construction management) as well.

Applying the Howey test to the facts above, the sponsored fund is relying on the efforts of the operating platform to realize profits from the sponsored fund's real estate investments. Accordingly, the fund is a passive investor in its real estate investments and such investments constitute investment contracts and thus securities for purposes of the Advisers Act. The fund's investment portfolio will constitute a securities portfolio if at least 50% of the total value of the investment portfolio consists of securities or the fund is a private fund, and the fund's investment adviser will be engaging "in the business of advising others . . . as to the advisability of investing in, purchase, or selling securities" for compensation.

As a counterfactual, if the general partner of the investment fund was capable of managing the real estate investments on its own, without relying on the efforts of a third-party investment adviser, the real estate assets would not constitute securities, because the real estate fund as the investor would not be relying on the efforts of a third party to realize profits from its investment. Rather, the fund would be relying on the efforts of one of its partners (the general partner) to realize its profits. Because the general partner is a partner of the partnership, and not a third-party, the partnership is an active, not a passive, investor and the investment is not an investment contract and so not a security.

As an aside, in both cases noted above, the limited partnership interests in the sponsored fund are clearly passive interests and therefore securities for purposes of the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"). Thus, internally managed real estate funds (such as most publicly listed REITs) are not subject to the Advisers Act, but the sale of interests in such REITs are subject to both the Exchange Act and the Securities Act.

Real Estate Funds Have Many of the Same Risks as Other Alternative Investment Funds

Regulating the sponsors of real estate funds as investment advisers is fully consistent with the essential purpose of the Advisers Act, specifically, protecting advisees and preserving the integrity of the financial services industry. The specific requirements of the Advisers Act and the regulations thereunder address issues as prevalent in real estate funds as in other alternative investment funds. For example:

- registered investment advisers are required to provide detailed information about the adviser and its business in both Part 1 and Part 2 of Form ADV and deliver the information in Part 2 to each client or prospective client;
- registered investment advisers are required to establish, maintain, and enforce a written code of ethics that includes a standard of business conduct and policies and procedures to ensure compliance with federal securities laws;

- registered investment advisers are prohibited from charging a fee on capital gains and capital appreciation except to qualified clients or private funds whose investors are qualified purchasers;
- registered investment advisers are prohibited from entering into advisory contracts that do not provide that assignments of the contract may be made only with the consent of the advisee;
- registered investment advisers are required to comply with specific procedures with respect to the custody of client funds and securities;
- registered investment advisers are prohibited from making certain political contributions to governmental entities to whom they provide investment advisory services; and
- registered investment advisers are required to maintain certain books and records and are subject to periodic examination to ensure compliance with the Advisers Act, including the anti-fraud provisions thereof.

The SEC enforces the Securities Act, Exchange Act, Advisers Act and Investment Company Act of 1940 (the "Investment Company Act"), in an integrated fashion to ensure that each investment product, service and transaction is subject to some type of risk-based regulation. Most real estate funds are marketed in private transactions to sophisticated investors and fall outside the scope of the Securities Act. These funds are usually marketed directly by the sponsors, who are not registered broker dealers, and are outside the scope of the Exchange Act. Finally, real estate funds generally satisfy one or more of the exemptions from registration as an investment company and are outside the scope of the Investment Company Act. Accordingly, the only substantive regulation applicable to externally managed real estate funds is the Advisers Act and adopting a reading of the Advisers Act that exempts real estate funds from its terms would leave these funds completely unregulated, contrary to the policy of the securities laws.

Real Estate Fund Investors Benefit from Adviser Registration

Given that both the plain text of the Advisers Act and its underlying policy requires the registration of real estate fund sponsors, real estate fund sponsors should register as required by applicable state and federal law. Further investors should be leery of any fund sponsor that is not so registered. Failure to register, whether at the state or federal level, or as an exempt reporting adviser, if applicable, indicates that the sponsor may not be cognizant of its legal obligations, and deprives the investor of the protections afforded by the Advisers Act, including periodic examination by the SEC.

This article does not constitute legal advice and is provided for general information purposes only. If you require specific legal advice, you should contact an attorney. Fragner Seifert Pace & Mintz, LLP can only offer legal advice to its clients who have engaged the firm for that purpose.

[Author Information Follows]

FSPM
Fragner Seifert Pace & Mintz

About Eric Rubenfeld

Eric Rubenfeld is a partner with Fragner, Seifert Pace & Mintz, LLP (f/k/a Fragner Seifert Pace & Winograd, LLP), a boutique law firm serving the legal needs of emerging and institutional business clients. Eric specializes in advising alternative investment advisers on all aspects of their business, including operational and transactional matters (including joint-ventures, financings, asset acquisitions and dispositions, fund formation and fund raising), dispute resolution, and regulatory compliance. Eric draws on his experience as a former principal, general counsel and CCO at multiple alternative investment firms and at top international law firms to deliver business savvy and cost-effective legal service to his clients.

Before returning to private law practice with FSPM in 2017, Eric spent over a decade as the general counsel and chief compliance officer of multiple multibillion-dollar institutional investment advisers specializing in private and public equity investments in real estate and corporate debt and equity. In addition to handling legal and compliance matters, Eric also managed HR and risk management and served on the management, investment, valuation, and risk and conflict committees.

Eric began his legal career practicing corporate law and litigation in New York City and Washington, D.C., including stints at Fried, Frank, Harris, Shriver & Jacobson and Arnold & Porter. Eric advised leading financial institutions, including Goldman Sachs, Morgan Stanley, Merrill Lynch and J.P. Morgan, in connection with their securities and structured product offerings, and represented private and public companies in litigation in both federal and state courts.

Eric earned his J.D., cum laude, from the Harvard Law School in 1995 and his B.A., magna cum laude and with college and departmental honors, from UCLA in 1991.

Eric recently:

- Represented a co-general partner in the formation of a new real estate private equity fund adviser and the formation of its first co-mingled fund
- Represented a private equity fund in assembling, financing, and selling a $300+ million data center portfolio in the United States and Canada
- Represented a private equity fund in $200 million of secured, property financings
- Represented a private equity fund in a $75 million shopping center construction loan
- Represented a private equity fund in $50 million subscription credit facility
- Advised a founding partner of a private equity firm in a business control dispute

- Represented a private equity fund in fund formation and operations, co-investment formation and operations, and regulatory compliance

Eric Rubenfeld Contact Information
1860 Bridgegate Street,
Westlake Village, CA 91361
Tel: 805-409-9427
ERubenfeld@fspmlaw.com

About Fragner Seifert Pace & Mintz, LLP

Fragner Seifert Pace & Mintz, LLP was founded nearly 20 years ago with one simple mission: to provide the highest quality legal services to real estate and business clients to help them achieve their business objectives with maximum efficiency. To accomplish this goal, we staff matters leanly with highly experienced attorneys who use time-tested strategies grounded in decades of experience to achieve efficient execution. Our quality over quantity approach results in lower cost and superior execution that yields benefits to our clients on an immediate, short-term and long-term basis.

Our core practice is representing sophisticated owners, operators, investors, lenders, and advisers in real estate and business matters, including entity formation and structuring, joint ventures, capital raising and financing, asset and stock acquisitions and dispositions, mergers and acquisitions, and leasing and operations, across the United States.

Our attorneys are licensed to practice law in California, Illinois, New Jersey, New York, Pennsylvania, and Texas.