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The Impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act on Real Estate Advisers and Real Estate Funds Exemptions: Part 1 of 2

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This article is presented in two parts. Part 1 explains how real estate advisers may structure their operations so that they are not "investment advisers" within the meaning of the Investment Advisers Act of 1940 (Advisers Act). Most states' securities laws contain a similar definition of "investment adviser" as the Advisers Act. Real estate advisers that successfully structure their operations so that they are not "investment advisers" would not be subject to registration and regulation under the Advisers Act, and likely, not subject to registration and regulation under applicable state law, although a definitive answer regarding state law would be dependent on a state-by-state analysis.

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The downside of this approach is that it would place heavy structuring limitations on the types of investments about which real estate advisers may advise clients and investors.

Part 2, appearing in an upcoming issue of *The Investment Lawyer,* will begin by providing a brief summary of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) as it relates to real estate advisers. Part 2 will then analyze the benefits and drawbacks of real estate advisers advising funds that rely upon different Investment Company Act of 1940 (Investment Company Act) exemptions, in light of Title IV of the Dodd-Frank Act. Part 2 will conclude by analyzing the securities structuring considerations for real estate funds seeking to rely upon various Investment Company Act exemptions.

The Ability of a Real Estate Adviser to Structure Operations so that it is not an "Investment Adviser" under the Advisers Act

Section 203(a) of the Advisers Act requires that all "investment advisers" register under the Advisers Act, unless exempt. The Advisers Act defines an "investment adviser" generally to include any person (including a natural person or an entity) who (1) for compensation; (2) is engaged in the business; (3) of providing advice to others or issuing reports or analyses regarding securities. Historically, these elements have been broadly construed by the SEC.[1]

The SEC Staff historically has taken an expansive view of what will be considered "in the business." "Generally speaking, this element will be satisfied if a person gives specific advice about securities other than in rare, isolated and non-periodic instances."[2] The SEC has said that a person can be an "investment adviser" even though giving investment advice is not his primary or even majority activity.[3] In making the determination whether a person is an "investment adviser," the SEC considers the following factors:

(1) Whether the person represents or otherwise holds himself out to the public as an investment adviser;
(2) Whether the person receives compensation for rendering investment advice; and
(3) The frequency or regularity of the investment advice given.[4]

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

Real estate fund advisers may find it difficult to structure their operations so that they are not engaged in the business of advising about "securities," since many types of investments that real estate fund advisers advise clients about are potentially "securities." Below, we explain how some of the most common real estate investments could be "securities" under the Advisers Act.

If real estate fund advisers advise persons or entities about investing in controlled partnerships, it is likely that they would not be advising about "securities." Appellate precedent suggests, albeit not in the Advisers Act context, that controlled partnership interests are not considered "securities."[5] Obviously, if the controlled partnership, in turn, invested in securities, then the real estate adviser would likely be considered to advise about "securities."

If real estate fund advisers advise persons or entities about investing in passive entity interests, then they are likely to advise them about "securities." Also, it would appear that joint ventures are likely not "securities" where profits are to come from the joint efforts of partners, as opposed to solely from the efforts of others.[6] However, if the joint venture, in turn, invested in securities, then the real estate adviser would likely be considered to advise about "securities."

In addition, if real estate fund advisers advise about investing in corporate stock, they would likely be advising about "securities," since the definition of "security" under Section 202(a)(18) includes "stock." The current approach of the courts, albeit not in the

Advisers Act context, does not require examination of the economic realities of a transaction when an instrument "is traditional stock, plainly within the statutory definition."[7]

Real estate fund advisers may also advise persons or entities about investing in securities if they advise them about investing in, without limitation, mortgage backed securities, asset backed securities, mortgage participation interests and industrial development bonds.

To the extent a real estate adviser is in the business of advising a person or entity about investing in "notes," complex issues arise surrounding whether such notes are "securities." On the one hand, the definition of "security" in Section 202(a)(18) of the Advisers Act includes the term "note." However, the Supreme Court has stated that not all notes are "securities."[8] Nonetheless, the Supreme Court, in analyzing whether a note was a "security," began with the presumption that a note was a "security."

The Supreme Court in *Reyes* stated that the presumption could be rebutted if the note were not a true investment and discussed an attempt by the Second Circuit to divide investment notes from notes that are not securities. The following notes were not generally securities: "the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized")."[9] Another case added to this list includes "notes evidencing loans by commercial banks for current operations."[10]

While the Supreme Court in *Reyes* acknowledged that the above types of notes were not "securities," it stated that other types of notes could also not be "securities" based on the above rationale. The Supreme Court in *Reyes* stated:

> First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security." … Second, we examine the "plan of distribution" of the instrument … to determine whether it is an instrument in which there is "common trading for speculation or investment" …. Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction. … Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.[11]

Nonetheless, in a prior no-action letter in the context of Section 202(a)(18) of the Advisers Act, the SEC Staff took the position that when a person in the business of giving advice about investments gives advice about a mortgage note (that is, a note evidencing debt on the acquisition of real estate), that mortgage note "could be a security pursuant to Section 202(a)(18) [of the Advisers Act]."[12] It should also be noted that this no-action letter took place prior to the decision in *Reyes*, but the decision in *Reyes* may only apply in the context of the Securities Act of 1933. No-action writers would have to seek relief in this regard.

There are additional ways in which a real estate adviser could become engaged in the business of advising about securities. A real estate adviser can be engaged in advising about securities if it advises about investing in fractional undivided interests in real estate by which a promoter or nominee assumes the responsibility of physical management of the property and distribution of the profits to the co-owners.[13] Advising about investing in condominiums and real estate development can also present securities issues. Professor Loss notes:

> In summary, the offering of condominium units in conjunction with any one of the following will cause the offering to be viewed as an offering of securities in the form of investment contracts: (1) the condominiums, with any rental arrangement or other similar service, are offered and sold with emphasis on the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter, from rental of the units; (2) the offering of participation in a rental pool arrangement; and (3) the offering of a rental or similar arrangement whereby the purchaser must hold his unit available for rental for any part of the year, must use an exclusive rental agent or is otherwise materially restricted in his occupancy or rental of his unit.

Real estate interests have also been held to be "securities" under the investment contract theory. In *Howey*, the Supreme Court held that the elements of an investment contract were: (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 a third party.[14]

In order to determine for "investment contract" purposes whether there is a common enterprise, subsequent courts have focused on whether there is horizontal commonality (that is, a pooling of investments) or vertical commonality.[15] Vertical commonality would ask whether the fortunes of the investors collectively are dependent upon promoter expertise. In the Ninth Circuit, vertical commonality has been specially defined as one in which fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment of third parties.[16] In the Ninth Circuit's view, pooling of investments (that is, horizontal commonality) is not required.[17]

In *Forman*, the Supreme Court analyzed whether there was a reasonable expectation of profits for "investment contract" purposes. *Forman* explained: "By profits, the Court has meant either capital appreciation resulting from the development of the initial investment as in Joiner … or a participation in earnings resulting from the use of the investors' funds, as in *Tcherepin v. Knight* (dividends on the investment based on savings and loan association's profits)."[18]

Today, the requirement that profits come solely from the effort of others is not read literally with respect to the "investment contract" analysis. The better view is that "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[19]

Needless to say, any number of circumstances could cause real estate to become "investment contracts" and therefore "securities." Below, we discuss a few of the most common "investment contracts" issues as they pertain to real estate interests.

"In situations where commercial facilities are a part of the common elements of a residential project, no registration would be required under the investment contract theory where (a) the income from such facilities is used only to offset common area expenses and (b) the operation of such facilities is incidental to the project as a whole and are [sic] not established as a primary income source for the individual owners of a condominium or cooperative unit."[20]

"[While] the sale of undeveloped lots normally would not involve a security, an investment contract may be found where the lots were sold for investment rather than residential use with emphasis on economic inducements in oral or written promotional materials."[21] Loss notes that "no investment contract is involved when a person invests in real estate, with the hope perhaps of earning a profit as the result of a general increase in values concurrent with the development of the neighborhood, as long as he does not do so as part of an enterprise in which it is expressly or impliedly understood that the property will be developed or operated by others."[22]

Certain types of real estate interests can be deemed "securities" outside of the "investment contract" context. A lease arrangement normally will not involve securities. However, in *Joiner*,[23] an oil prospector named Joiner acquired oil and gas leaseholds in a 3000 acre tract in Texas. Joiner then sought to sell fractional interests in leaseholds in specific portions of the tract. The acreage would be selected by the promoters. The promoter suggested that investors would earn profits by the efforts of the promoter to drill in the acreage. The court held that this type of a lease was a security. Although *Joiner* took place in the oil and gas lease context, the case illustrates that under certain circumstances a lease can be considered a security. Loss theorizes that this occurs where "the combination of a lease and other economic inducement whose value is substantially dependent on the efforts of a promoter or other parties … create[s] an *investment contract*."

Several courts have noted in the context of real estate that the term securities could be construed as follows: "the test rather is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect. In the enforcement of (securities acts) it is not inappropriate that promoters' offerings be judged as being what they were represented to be."[24] Thus, real estate investments that are held out as securities investments, or that are treated as securities for commercial purposes could potentially fall within the meaning of "securities." Thus, real estate advisers desiring to avoid being considered "investment advisers" within the meaning of the Advisers Act would not want to hold themselves out as advising about securities.

It should also be noted that a real estate fund adviser could be considered an "investment adviser" through its recommendation to investors to invest in a fund that it sponsors. Here, real estate fund advisers can potentially mitigate the risk that they are in the business of providing advice about "securities" by limiting their advice about "securities" to one-off advice to invest in their fund 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. Even safer, the real estate adviser could explicitly state that it is not able to provide recommendations to invest in the fund.

This discussion is not intended to be exhaustive of every potential scenario that could lead to a real estate adviser being considered an "investment adviser," but to set forth some issues that real estate fund advisers will want to consider when they sponsor real estate funds. Real estate fund advisers will also need to consider that under Section 208(d) of the Advisers Act, they will not be able to structure their operations indirectly to accomplish what would be illegal under the Advisers Act, if done directly. However, Section 208(d) likely should not prohibit legitimate structuring attempts.

In addition, real estate advisers will need to consider whether not being subject to registration and regulation under the Advisers Act (and potentially state law) is worth the burden of being restricted by not being able to be in the business of advising about "securities." Real estate advisers should understand if they decide to structure their operations so that they are not "investment advisers" that there could be considerable uncertainty regarding what would be considered advising about "securities." No-action guidance may be advisable.

Notes

1. Thomas P. Lemke and Gerald T. Lins, Regulation of Investment Advisers, §1:3.

2. *Id.*, §1:5.

3. Hauk, Soule & Fasani, P.C., SEC No-Action Letter, 1986 WL 66619 (May 2, 1986).

4. College Resource Network, SEC No-Action Letter, 1993 SEC No-Act. LEXIS 630 (April 9, 1993).

5. *See* Rodeo v. Gillman, 787 F.2d 1175 (7th Cir. 1986); Klaers v. St. Peter, 942 F.2d 535 (8th Cir. 1991).

6. Louis Loss and Joel Seligman, Securities Regulation, 4th, §3-A-1.

7. *Id*.

8. Reyes v. Ernst & Young, 494 U.S. 56 (1990).

9. Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126 (2nd Cir. 1975).

10. Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930 (2nd Cir. 1984).

11. Reyes v. Ernst & Young, *supra* n.8.

12. Ken Flood, SEC No-Action Letter, 1984 SEC No-Act. LEXIS 1976 (March 2, 1984).

13. Securities Regulation, *supra* n.6, §3-A-1, at text accompanying n.232.

14. SEC v. W.J. Howey & Co., 328 U.S. 293 (1946).

15. Securities Regulation, *supra* n.6, §3-A-1.

16. *Id*.

17. *Id*.

18. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 855 (1975).

19. Securities Regulation, *supra* n. 6, §3-A-1; SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476, 482 (9th Cir. 1973).

20. *Id*. (n.234 noting that this analysis has been widely followed).

21. Securities Regulation, *supra* n. 6, §3-A-1.

22. *Id*. *See also* United States Hous. Found., Inc. v. Forman, *supra* n.18; McCown v. Heidler, 527 F.2d 204 (10th Cir. 1975) (explaining that land, as such, is not a security and that a land purchase contract, simply because the purchaser expects or hopes that the value of the land purchased will increase, does not fall automatically within the confines of the Securities Act of 1933).

23. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943).

24. *Id*. at 352-3.