

Strictly Business

A Business Law Blog for Entrepreneurs, Emerging Companies, and the Investment Management Industry.



ABOUT THE AUTHOR

Alexander J. Davie is an attorney based in the Nashville, TN area. His practice focuses on corporate, finance, and real estate transactions. He works mainly with emerging companies, venture funds, entrepreneurs, and startups. His firm's website can be found at www.alexanderdavie.com.

In his corporate practice, Mr. Davie has worked extensively with his clients on all aspects of their businesses, including company formation, business planning, mergers and acquisitions, vendor and customer contracts, corporate governance, debt and equity financings, and securities offerings. In addition, he has represented investment advisors, securities brokers, hedge funds, private equity funds, and real estate partnership syndicators in numerous private offerings of securities and in ongoing compliance. Prior to returning to private practice, Mr. Davie served as the general counsel to a private investment fund manager.

In his real estate practice, he has participated in property acquisitions, mortgage financings, and commercial leasing matters throughout the United States. He has represented developers, governmental entities, life insurance companies, banks, and owners of malls, shopping centers, industrial parks, and office towers. He has worked on a number of transactions involving the syndication of real estate partnerships, advising sponsors on both real estate and securities issues.

Are real estate fund managers required to be registered as investment advisers?

After my [recent post](#) regarding exemption from investment adviser registration of venture capital funds and small hedge funds, I had a number of people ask me about the status of real estate funds under the new regime. Do the managers of real estate investment funds and partnerships need to register as investment advisers either under the pre or post-Dodd-Frank regime? The answer has always been somewhat ambiguous, but in my view, if the fund is a true real estate fund (i.e. it buys only real estate rather than interests in companies that own real estate), then its manager does not have to register. The Dodd-Frank Act did not change this analysis.

The definition of an "investment adviser" under the Investment Advisers Act is "any person who, for compensation, engages in the business of advising others... as to the value of securities or as to the advisability of investing in, purchasing, or selling securities." The key word in that definition is the last one. If a fund does not invest in securities, then its manager or adviser is not acting as an investment adviser, which means that its activity falls completely outside the scope of the Investment Advisers Act.

So when is real estate a security and when is it not? The definition of the word "security" is complex, encompassing extensive statutory definitions and a long line of case-law. If you are interested in the legal reasoning behind what real estate assets are and aren't securities, Doug Cornelius, a fellow legal blogger, has posted [a great discussion of it here](#), so I won't reinvent the wheel by repeating it. However, I will provide some practical guidelines to use in analyzing your own situation.

Here are how I believe each real estate asset type would be classified:

- **Direct Real Estate Ownership.** A direct fee simple interest in real estate would not generally be considered a security. However, a TIC (tenant in common) interest in real estate may or may not be a security depending on the degree of control the fund maintained. If the fund has control or is active in the management of the real estate, it will likely not be a security, but if the fund is a passive owner, it likely will be considered a security.

- Stock. Stock in a corporation that owns real estate would always be considered a security. There may be an exception if the corporation is a wholly owned subsidiary of the fund, but it would not be a good idea to test this, since courts have come pretty close to ruling that stock is always a security.
- Partnership and LLC Interests. A limited partnership interest in a partnership that owns real estate or a non-managing member interest in a limited liability company that owns real estate is likely to be a security. A general partnership interest in a partnership or a managing member (or a member of a member-managed LLC) generally is not a security. Fee simple real estate owned by a wholly owned LLC subsidiary of the fund would likewise not be a security.
- Joint Ventures. With joint ventures, the situation depends on the degree of active participation. Similar to the discussion above, re: partnerships and LLCs, if the fund is an active participant, generally its interest is not a security, but if the fund is passive, then the interest could be deemed to be a security.
- Commercial Mortgage Loans. Common sense would say that commercial mortgage loans would not be a security, because if they were, every borrower would also be an issuer of securities. This is obviously not the case. However, securities laws provide that any "note" is presumptively a security unless the context would indicate otherwise. Therefore,

a fund that owns a portfolio of commercial mortgages that it purchased from a non-affiliated originator would likely be considered to be holding a securities portfolio. However, if the fund were to instead make direct commercial mortgage loans to borrowers, then the context would likely dictate that the loan is not a security.

As you can see, determining whether a specific asset is a security can be complex. In addition, it may often be the case that a fund's assets may consist mainly of real estate but the fund also owns a smaller amount of its assets in other categories such as limited partnership interests. The Investment Company Act (a separate statute from the Advisers Act) generally provides that a company will be considered an investment company (i.e. a portfolio of securities), if the securities owned by that company has a value exceeding 40 percent of the value of the company's total assets. Arguably, if a fund is not considered to be a securities portfolio, then its manager would also not be considered to be an investment adviser. This line of reasoning has yet to be tested by the SEC or the courts.

Given the very fact specific nature of these issues, you should consult a qualified attorney in making the decision of whether to register as an investment adviser.

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