THE RISE OF THE DODD-FRANK ACT: HOW DODD-FRANK WILL LIKELY IMPACT PRIVATE EQUITY REAL ESTATE

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This paper argues that the Dodd-Frank Act attempted to prevent against systemic risks in response to the financial crisis of 2008, but poses over-regulation dangers on private equity real estate, which the regulators acknowledged weren’t the cause of the financial crisis. The author examines private equity real estate along three axes of systemic risk contributors, aggregate industry size, financial connections, and synchronization with other schemes and markets. It further compares private equity real estate funds to hedge funds, which have been viewed by some as posing systemic risks. The unraveled evidence strongly suggests that private equity real estate doesn’t give rise to systemic risk concerns, yet the Dodd-Frank Act threatens to subject private equity real estate advisers to tightened regulations, which impose considerable compliance costs and particularly burden small and/or start-up firms. To assist private equity real estate advisers with their new paths through the regulatory landscape, this article provides a complex compliance framework that could potentially help them restructure their funds to minimize the impact of the Dodd-Frank on their compliance burdens. This article argues that the SEC should accept these new paths as part of the new regulatory landscape for private equity real estate, given the policy reasons expressed in this article. It further recommends that the regulators not apply the Volcker Rule against private equity real estate. Recognitions of these new paths and limiting the application of the Volcker Rule would increase transactional certainty for private equity real estate, foster their freedom of choice to select the best regulatory path, and most importantly, avoid the

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dangers of over-regulation for private equity real estate.

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In July 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Dodd-Frank" or "the Act").¹ Dodd-Frank was a sweeping financial legislation that, among other things, drastically altered the regulatory landscape for private equity and subjected many private equity advisers to much tighter regulation.

Prior to the enactment of the Dodd-Frank Act, private equity investment advisers had been largely unregulated under the Investment Advisers Act of 1940 (“Advisers Act”)² and the Investment Company Act of 1940 (“Investment Company Act”).³ During the years leading up the enactment of the Dodd-Frank Act, private equity flourished. As of March 2012, private equity funds’ global assets under management, including dry powder (capital commitments not employed in investments) totaled approximately $3 trillion.⁴ Note, however, that private equity real estate (also “PERE”) funds, which are the subject of this article, have a much smaller industry size, evidenced by the fact that there were, as of the third quarter of 2013, only “468 private equity real estate funds (targeting assets rather than other funds) seeking an aggregate of $154 [billion] in capital commitments.”⁵

Looking deeper, one may also postulate that the freedom of private equity investment strategies lies inherently in the free regulatory pass that many private equity advisers and private equity funds received prior to the inauguration of the Dodd-Frank Act. For example, it is widely known that Yale University’s private equity investments from 1973 to 2006 had a

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². The Advisers Act is a body of federal securities laws that regulates “investment advisers.”

³. The Investment Company Act is a body of federal securities laws that regulates the funds with which investment advisers work.


greater than 30% rate of return overall. 6 Many scholars attribute such impressive, above-market returns to the fluidity of private equity funds’ investment strategies.

Admittedly, some studies suggest that private equity, as an industry at large, does not generate above-market returns. 7 Yet, many successful individual private equity players who outperform in one fund have been observed to persistently outperform in future funds. 8 Thus, the fluidity of private equity, at a minimum, provides many talented private equity advisers with the possibility of consistently outperforming the market, which may be advantageous for investors.

In light of these economic benefits, private equity advisers clearly have solid grounds for viewing private equity as an important tool for society, especially for investors. Private equity advisers may therefore likely consider less regulation as a significant contributing factor for the success of private equity, and hence the success and growth of investors’ wealth and the national economy.

Following the financial crisis of 2008, stampeded by poor mortgage lending practices, regulators across the country reached a heightened state of alert. This motivated Congress to enact the Dodd-Frank Act in 2010, primarily to address systemic risk concerns:

Congress [held] hearings on systemic risk in response to the . . . subprime mortgage crisis and its impact on the mortgage-backed securities and commercial paper markets. The U.S. Federal Reserve, the European Central Bank, and other monetary agencies worldwide . . . likewise expressed concern about this crisis and its potential systemic effects, dramatically illustrated by the collapse of the investment bank Bear Stearns. Governments also [were] concerned about the potential for systemic failure stemming from hedge-fund collapses, originally raised by the near-failure of Long-Term Capital Management and more recently prompted by the unregulated spread of hedge funds as a favored investment tool. 9

8. See id. (“General partners (GPs) whose funds outperform the industry in one fund are likely to outperform the industry in the next and vice versa.”).
The financial crisis of 2008 clearly had the potential to bring down the economy. However, private equity did not contribute to this financial crisis. The legislative history for the Volcker Rule\(^\text{10}\) notes, “The erosion of lending standards and the Federal Government’s poorly conceived efforts to subsidize mortgage lending caused the financial crisis . . . .”\(^\text{11}\) The massive mortgage defaults and the resulting decline of mortgage-backed securities (“MBS”) eventually caused the collapses of several major financial institutions in September 2008, signaling how mortgage defaults and MBS could give rise to systemic risk concerns. The subprime mortgage crisis threatened to trigger a systemic collapse by weakening large financial institutions:

Governments responding to the financial crisis initially concluded that these financial institutions were “too big to fail.” [However, after 2008,] any government officials believed that, because of the interconnectedness of each firm with the rest of the American and global economy, the failure of the financial institutions could cause the entire global financial system to collapse.\(^\text{12}\)

This prompted Congress to take preventative measures against systemic risks, as a prudent doctor is apt to prescribe preventative medicines against potential heart and kidney damage for a patient with a diagnosed liver disease. Accordingly, the Dodd-Frank Act imposed substantial rules that regulated the financial system beyond mortgage lending practices.

The primary goal of the Dodd-Frank Act was to cure the problem of poor mortgage lending practices and the subsequent issues of the MBS markets. The Act “enact[ed] numerous provisions intended to reform the mortgage lending industry with an eye towards consumer protection. Many of these provisions are contained within Title XIV of the Dodd-Frank Act, [and] the Mortgage Reform and Anti-Predatory Lending Act (the ‘Mortgage Act’ . . . ).”\(^\text{13}\) In addition,

\(^{10}\) The Volcker Rule, a part of the Dodd-Frank Act, prohibits banks from sponsoring or owning private equity funds exempt under Sections 3(c)(1) and (3)(c)(7) of the Investment Company Act.


\(^{13}\) Bradley K. Sabel, Mortgage Lending Practice after the Dodd-Frank Act, posting in The Harvard Law School Forum on Corporate Governance and Financial Regulation, WEBLOGS AT HARV. L. SCH. (Nov. 16, 2010, 10:03 AM),

Even though the Dodd-Frank Act was intended to fix the cause of the financial crisis, two portions of the Act substantially impact the private equity industry, which was not the cause of the crisis. The two portions are Title IV and the Volcker Rule. Title IV amends the registration regime of the Advisers Act in a way that forces many private equity advisers, who were previously unregistered, to register thereunder. 15 The Volcker Rule prohibits banks from sponsoring or owning private equity funds exempt under Sections 3(c)(1) and (3)(c)(7) of the Investment Company Act, but the Dodd-Frank Act grants the joint agencies the discretion to also apply the Volcker Rule directly against non-(c)(1)/(c)(7) exempt funds. 16

The legislative history for Title IV notes that Title IV requires many previously exempt advisers to register in order to monitor hedge fund systemic risks:

While hedge funds are generally not thought to have caused the current financial crisis, information regarding their size, strategies, and positions could be crucial to regulatory attempts to deal with a future crisis. The case of Long-Term Capital Management, a hedge fund that was rescued through Federal Reserve intervention in 1998 because of concerns that it was “too-interconnected-to-fail,” indicates that the activities of even a single hedge fund may have systemic consequences. 17

The legislative history thus indicates that Title IV seeks to apply the Advisers Act against hedge funds and other types of “private funds” that may give rise to systemic risks.

The legislative history for the Volcker Rule begins by noting that the Volcker Rule prohibits banking activities “that are high-risk or which create significant conflicts of interest between these institutions and their


14. Id.

15. Information about general issues regarding investment adviser jurisdiction, registration, statutory floors, exemptions, and compliance under the Advisers Act and the Dodd-Frank Act can be found in a companion article. Dodd-Frank Act, supra note 1, § 619(a)(2)(B).

16. Id. § 619(b)(2).

customers, such as “the possibility that firms will favor inside funds when placing funds for clients.” When losses from high-risk activities are significant, they can threaten the safety and soundness of individual firms and contribute to overall financial instability. Moreover, when the losses accrue to insured depositories or their holding companies, they can cause taxpayer losses. An additional point in the legislative history of the Volcker Rule is that “[t]he prohibitions also will reduce the scale, complexity, and interconnectedness of those banks that . . . have hedge fund or private equity exposure.” Clearly, the primary focus of the Volcker Rule is to prevent systemic risks to the economy as a whole.

Following the Dodd-Frank Act, all private equity advisers, including hedge fund advisers, are now subject to new, burdensome regulation. This new regulation seems inconsistent with the historical reasons for private equity’s regulatory free pass as well as the fluidity of private equity funds' investment strategies. In particular, regulators felt duty-bound to take preventative measures and increase oversight of private equity investment advisers in order to minimize potential systemic risks; although, as discussed above, the legislators recognized that private equity funds were not the cause of the financial crisis.

Increased regulation of private equity potentially presents dangers, considering that “[o]ver-regulation of economic markets acts as a drag on investment and entrepreneurial enterprise” and that “over[-]regulation will suffocate the economy and deepen the crisis.” Moreover, “over-regulation may prevent financial institutions from doing business in a cost-effective manner and drive financial activity to other, more favorably regulated markets.” In particular, Title IV of the Dodd-Frank Act, which threatens to subject private equity real estate advisers to the Advisers Act, will impose considerable compliance costs, which could be particularly burdensome for small and/or start-up firms. For example, one fund “took about 2,000 hours to prepare its first Form PF filing. Another . . . fund [had] about 140 employees, eight to ten of whom work[ed] full time on regulatory compliance.” In addition, “[c]ompliance is very expensive for

18. Id. at 8.
19. Id.
20. Id.
21. Id.
25. Lloyd Dixon, Noreen Clancy & Krishna B. Kumar, Hedge Funds, Systemic Risk,
[small] firms because they either have to dedicate some of their small staff to compliance or pay to outsource the compliance to another firm. At the same time, these firms are pressured by their investors to reduce fee-related expenses.” Additionally, too much regulation could potentially cause private equity funds that cannot cope with the compliance costs and efforts to relocate to jurisdictions where regulation is less intense, which is not advantageous for the U.S. economy.

On the side of the Volcker Rule, applying the Volcker Rule against PERE would cut off a significant source of capital to PERE funds, even though banks are not a gigantic percentage of PERE’s investors. This is problematic, since PERE has had a significant role in paving the way to the recovery of the real estate markets after various financial crises. Further, PERE funds that invest in land should help lead the way to recovery of development activities for the country’s GDP, which is also particularly important. Cutting off that source of capital might also put PERE in the United States at a competitive disadvantage with global PERE funds.

Given that the Dodd-Frank Act took preventative measures beyond mortgage lending practices, and even beyond subjecting hedge funds to tightened regulations, there is a great possibility of over-regulation dangers - just as taking medicines before multi-organ failure could ultimately damage a patient’s health.

In the face of these changes, this paper predicts that private equity advisers will not only comply, but also adapt. This article predicts that traditional private equity investment advisers, who largely advise about investments in non-real estate securities, will have a very limited ability to adapt to the Dodd-Frank Act, and will have to comply in a rather straightforward way.

The lack of adaptability for traditional private equity investment advisers derives, foremost, from the fact that such advisers focus on investments in “securities,” and, according to the Advisers Act, they fall into the category of “investment advisers.” The Advisers Act defines “investment advisers” as “any person who . . . 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.” Consequently, traditional...
private equity investment advisers will have no ability to sidestep the Advisers Act.

In addition, the Dodd-Frank Act imposes new, additional regulations on investment advisers to funds exempt under Sections 3(c)(1) and 3(c)(7). One such regulation is the filing of Form PF, required of investment advisers who manage one or more “private funds” if the adviser or its related persons, collectively, “have at least $150 million in private fund assets under management as of the last day of [the adviser’s] most recently completed fiscal year.” Another such regulation is the Volcker Rule, which prohibits banks from sponsoring or owning Sections 3(c)(1) and 3(c)(7) exempt funds. Traditional private equity funds typically have no choice but to rely upon the Investment Company Act’s Sections 3(c)(1) and 3(c)(7) exemptions. This is because several important non-(c)(1)/(c)(7) exemptions are primarily aimed at unconventional funds, which invest in non-securities or real estate. As a result, traditional private equity advisers will be unable to sidestep the new regulations of the Dodd-Frank Act, most notably the Volcker Rule and Form PF, which apply to advisers who advise Sections 3(c)(1) and 3(c)(7) exempt funds.

However, this article predicts a more flexible adaptive approach for private equity real estate investment advisers, rather than rigid compliance with the new rules. In order to alleviate over-regulation dangers for private equity real estate, especially in light of the fact that private equity real estate does not pose systemic risk concerns and possesses typically only moderate investment risks, this paper sets forth new paths for private equity real estate advisers through the new regulatory landscape. This paper shows how private equity real estate investment advisers will likely forge new strategies in the new regulatory landscape following Dodd-Frank, which will lighten their compliance and administrative costs. It is important to realize that such trailblazing possibilities are beneficial to society; private equity real estate should not bear substantial costs because it does not generate systemic risks. Otherwise, the Dodd-Frank Act will

The interpretation of Section 202(a)(11) is subject to considerable nuance.

29. 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.” Investment Company Act of 1940 § 3(c)(1), 15 U.S.C. § 80a-3(c)(1) (2006).

30. Section 3(c)(7) generally exempts “[a]ny 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.” Id. § 80a-3(7)(A).

over-regulate private equity real estate.

Private equity real estate advisers will naturally feel inclined to navigate the regulatory landscape in the most advantageous way possible, given their liberal view that light regulation is essential for faster economic growth and given the considerable compliance costs Dodd-Frank would otherwise impose on them. This paper attempts to provide the groundwork for regulatory navigation and to explain why this behavior will help avoid the dangers of private equity over-regulation, since private equity real estate does not pose systemic risk concerns.

In regards to the Advisers Act generally, private equity real estate investment advisers might be able to sidestep the Act by avoiding investment advice about “securities.” In addition, private equity real estate advisers might be able to sidestep the Volcker Rule or other new additional regulations applicable to advisers to (c)(1)/(c)(7) exempt funds, by restructuring their funds into non-(c)(1)/(c)(7) exempt funds. As discussed above, many important non-(c)(1)/(c)(7) Investment Company Act exemptions are aimed at funds that invest in non-securities or real estate.

This article posits that these new paths will be acceptable to the regulators, given the long-standing tradition of regulators’ classifying non-securities real estate investments as falling outside the scope of the Advisers Act, and given both the absence of systemic risk concerns as well as the typically merely moderate investment risks of private equity real estate in general. The absence of systemic risk concerns posed by private equity real estate is further evidenced by the fact that the finalized version of Form PF mandates certain registered investment advisers to report risk exposure statistics but there is no indication that it applies to private equity real estate funds that utilize non-(c)(1)/(c)(7) exemptions.

More specifically, Part II expounds the policy analysis for the legitimacy of these side roads through the new regulatory landscape, given the lack of systemic risk concerns posed by private equity real estate. It explains the meaning of systemic risks and presents strong evidence for the low systemic risks posed by private equity real estate. With respect to the Advisers Act, the author argues for the validity of the private equity real estate advisers’ intention to be exempt from the Advisers Act by exclusively investing in non-securities, which regulators have acknowledged as falling outside the scope of the Advisers Act.32 Regarding regulations applicable to investment advisers of “private funds” (i.e., (c)(1)/(c)(7) funds), the author postulates that it was likely the

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32. See Regulation of Investment Advisers by the U.S. Securities and Exchange Commission, SEC AND EXCH. COMM’N 3 (Mar. 2013), http://www.sec.gov/about/offices/oia/oia_investman/plaze-042012.pdf [hereinafter Regulation of Investment Advisers] (“The SEC staff has stated that advice about real estate, coins, precious metals, or commodities is not advice about securities.”).
regulators’ intention to have left non-(c)(1)/(c)(7) exemptions in the hands of private equity real estate to bypass such regulations, since, for example, the SEC’s finalization of Form PF did not apply to private equity real estate funds utilizing non-(c)(1)/(c)(7) exemptions.

Regarding the Volcker Rule, this paper provides compelling evidence that the regulators should not use their discretion to apply the Volcker Rule against private equity real estate advisers utilizing non-(c)(1)/(c)(7) exemptions, since private equity real estate does not generate systemic risk concerns and possesses typically only moderate investment risks. The author strongly urges the joint agencies charged with issuing a final ruling on the Volcker Rule not to apply the Volcker Rule against private equity real estate utilizing non-(c)(1)/(c)(7) exempt funds. Further, it would not be in the best interest of society to apply the Volcker Rule against private equity real estate, given that private equity real estate has had a central role in the recovery of the real estate markets following the financial crisis of 2008.

In order to assist private equity real estate advisers with the new regulatory landscape, this article sets forth the compliance framework for how private equity real estate investment advisers, who would otherwise fall within the definition of an “investment adviser” and be subject to U.S. jurisdiction, may structure their operations so as not to be subject to the Advisers Act or potentially even to applicable state law. Avoiding advising about “securities” would theoretically prevent private equity real estate investment advisers from having to register with the SEC, and would likely prevent them from being subject to relevant Advisers Act regulations, both of which they would otherwise find burdensome. In principle, this type of structuring would also likely permit the funds that private equity real estate advisers advise to bypass the Investment Company Act and the Volcker Rule, since these funds would become non-securities funds, and thus usually not “investment companies” within the meaning of the Investment Company Act.

However, the downside of this type of structuring is that it could severely limit the types of investments about which a private equity real

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33. The analysis in Part I of this article assumes that a real estate investment adviser is subject to U.S. jurisdiction. See Seth Chertok, *A Comprehensive Guide to Title IV of the Dodd-Frank Act and the Rules Promulgated Thereunder*, 12 U.C. DAVIS BUS. L. J. 125 (2012) for a discussion of how investment advisers become subject to U.S. jurisdiction. One way of avoiding the issues raised by this article is to structure the investment adviser so that it is not subject to U.S. jurisdiction, in which case the Advisers Act would not apply.

34. The definition of “investment adviser,” according to most states’ securities laws, is similar to that found in the Advisers Act.
estate investment adviser could provide investment advice. Many types of real estate investments potentially have a securities aspect to them, such as, without limitation, passive entity investments, mortgage-backed securities and mortgage participation interests. This limitation might be workable for many types of private equity real estate advisers, since most types of private equity real estate funds really strive to engage in operating and developing real properties, and don’t target securities investments. Nonetheless determining whether a real estate investment is a security often entails resolutions of complex, fact-specific securities questions under federal and state law, although hopefully the guidance provided by this article will ease some of that burden. Inexperienced investment advisers may want to consult with experienced counsel to recognize and address these issues.

Part IV considers how, in the event that a private equity real estate investment adviser could not shed the title of an “investment adviser” as defined by the Advisers Act, the adviser may want to restructure its real estate funds to benefit from non-(c)(1)/(c)(7) Investment Company Act exemptions. The Dodd-Frank Act contains several provisions that regulate investment advisers to “private funds,” including, without limitation, Form PF and the Volcker Rule. “Private funds,” a term added to the Advisers Act by the Dodd-Frank Act, includes an investment fund “that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), but for section 3(c)(1) or 3(c)(7) of that Act.” By only advising funds that are non-(c)(1)/(c)(7) exempt funds, such as funds exempt under Sections 3(a)(1), 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) and 3(c)(9) of the Investment Company Act, private equity real estate advisers may benefit in two ways. The advisers may (1) be able to avoid provisions under the Advisers Act created by the Dodd-Frank Act that regulate “private funds” and (2) possibly bypass the Volcker Rule, should the joint agencies limit their discretion by not applying the Volcker Rule against non-(c)(1)/(c)(7) exempt funds. The author strongly recommends that the joint agencies limit their discretion in this regard,

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35. See infra Part II for a discussion of when these investments are considered to involve securities.


37. Dodd-Frank Act § 402(a). The definition of an “investment company” is beyond the scope of this article, but subject to certain exceptions, the term generally includes, without limitation, most types of companies that (i) invest more than forty percent of their total assets (excluding government securities and cash) in securities on an unconsolidated basis or (ii) hold themselves out as primarily engaged in the business of investing in securities. Investment Company Act § 3(a)(1)(A), (C)(1940). The interpretation of these requirements is very complex and subject to considerable nuance.
which is what they have proposed to do.

Last, in Part V, this article analyzes the complex securities structuring considerations for private equity real estate funds seeking to rely upon the exemptions in Sections 3(a)(1), 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) and 3(c)(9) of the Investment Company Act. Traditionally, many private equity real estate funds have relied upon Section 3(c)(1) or 3(c)(7) of the Investment Company Act due to the fact that the exemptions under Sections 3(a)(1), 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) and 3(c)(9) require a more complicated securities analysis. Relying upon the Section 3(a)(1), 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) and 3(c)(9) exemptions would therefore entail considerable compliance hurdles. By laying down the compliance groundwork for private equity real estate investment advisers seeking to rely upon non-(c)(1)/(c)(7) exemptions, the author hopes to ease the burdens of the complexity of the relevant securities analysis. Private equity real estate investment advisers seeking to avoid their funds being deemed “private funds” will have to balance the burden of these compliance hurdles against any potential benefits under the Dodd-Frank Act.

I. POLICY ANALYSIS

This article focuses on two major aspects of the Dodd-Frank Act’s impact on private equity real estate regulation: (1) the Advisers Act registration; and (2) the portions of the Dodd-Frank Act that regulate investment advisers to “private funds,” most significantly, but not limited to, the Volcker Rule and Form PF. If private equity real estate advisers are able to sidestep the Advisers Act, they will avoid the Advisers Act registration and regulatory impact created by the Dodd-Frank entirely (including very likely the Volcker Rule). If this cannot be accomplished, the private equity real estate advisers could still seek alternative solutions, such as seeking non-(c)(1)/(c)(7) Investment Company Act exemptions, to sidestep the portions of the Dodd-Frank Act pertinent to “private funds” investment advisers.

As summarized in the introduction, the author argues for the legitimacy of the advisers seeking to sidestep both (1) and (2) mentioned above, because of the liberal stance taken by the SEC toward non-securities real estate investments and because of the SEC’s finalization of Form PF, which does not apply to private equity real estate funds utilizing non-(c)(1)/(c)(7) exemptions.

Furthermore, the author believes that regulators likely intended these new side paths, since private equity real estate does not generate systemic risk concerns.
A. Systemic Risk Concerns of Private Equity Real Estate

Before tackling new routes to navigate through the rocky regulatory landscape, one must ask whether adapting to regulation is positive for society from a policy perspective. This article answers in the affirmative. In order to arrive at this answer, it is necessary to recap the legislative history of Title IV and the Volcker Rule of Dodd-Frank.

As discussed in the introduction, the legislative history for Title IV notes that Title IV requires many previously exempt advisers to register with a primary intention to monitor hedge fund systemic risks. The legislative history for the Volcker Rule suggests that Congress sought to apply the Volcker Rule to (1) banking investments that might be too risky, (2) banking investments that might threaten American financial stability or give rise to systemic risks and (3) banking investments that might result in the need for another bank bailout at the expense of taxpayers.

This section will ultimately show that none of the concerns of Title IV or the Volcker Rule applies to private equity real estate. However, in order to show that this is true, we must first understand the exact meaning of “systemic risks.”

1. Systemic Risks Defined

“There is . . . a great deal of confusion about what types of risk are truly ‘systemic’ – the term meaning ‘[o]f or pertaining to a system’ . . .”\(^{38}\)

“As a result, the ‘very definition [of systemic risk] is still somewhat unsettled.’\(^{39}\) This is problematic for society. “If a problem cannot be defined, it cannot be solved – or, at least, it cannot be efficiently solved – because confusion over the nature of the problem can obscure attempts to provide solutions.”\(^{40}\)

In his 2008 paper “Systemic Risk,” Professor Schwarcz sorts through the different threads of “systemic risk” definitions to create a synthesized definition that functions for regulatory purposes. The article begins by noting:

A common factor in the various definitions of systemic risk is that a trigger event, such as an economic shock or institutional failure, causes a chain of bad economic consequences – sometimes referred to as a domino effect. These consequences could include (a chain of) financial institution and/or market failures. Less dramatically, these consequences might include (a

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38. Schwarcz, supra note 9, at 196.
39. Id.
40. Id. at 197.
chain of) significant losses to financial institutions or substantial financial-market price volatility. In either case, the consequences impact financial institutions, markets, or both.\textsuperscript{41}

Schwarcz describes the most serious direct consequences of systemic failure as the failure of banks and other financial institutions, which, “[E]specially in large numbers, can deprive society of capital and increase its cost.”\textsuperscript{42} While Schwarcz’s ideas are very helpful, they do not provide a tool to assess whether an investment scheme generates systemic risks.

One simple analogy to the financial systemic effect is a physical network of nodes, composed of metal balls and linked by metal chains, where the vibration of one node is violent enough to break the whole network of chains and balls. The physical property of the network is such that three characteristics of its components would determine the breakability of the whole network: (1) The weight of a given ball, relative to the total mass of the network; the heavier it is, the larger percentage of its weight is in the total weight of the network, the more likely its vibration will lead to the breakage of the network; (2) The strength of a given ball’s connections to the rest of the nodes along the chains; the stronger its connections to the other nodes, the higher the chance is for it to exert a systemic impact on the whole network; (3) The resonant tendency between a given ball and other balls across the chains; the more closely the ball’s oscillations match the system’s natural frequency of vibration, the more likely that its own violent motions may lead to a catastrophic collapse of the whole system, a phenomenon known in physics as “resonance disaster.”

So, what significance does a physical chain of nodes carry for the financial systemic effect of our interest? Interestingly, many financial phenomena operate under similar laws as physical phenomena in life. The translation of the above three characteristics into economic terms would be: (1) The industry size of an investment scheme or group of financial institutions, relative to the markets in which they operate, and possibly other markets that might subsequently be affected by them; (2) The financial and operational connections between one investment scheme and other markets as well as the causal relationship between them; (3) The synchronization between one investment scheme’s gain/loss and other types of schemes’ gain/loss across the markets, with or without possible time delays.

A classic example of financial institution systemic failure often referred to by economic scholars is “a ‘bank run,’ in which the inability of a bank to satisfy withdrawal-demands causes its failure, in turn causing

\textsuperscript{41} Id. at 198.

\textsuperscript{42} Id.
other banks or their creditors to fail.”

If a bank cannot pay all withdrawal-demands, it will default and ultimately fail, possibly causing a “chain of subsequent failures [to] occur because banks are closely intertwined financially. They lend to and borrow from each other, hold deposit balances with each other, and make payments through the interbank clearing system . . . .”

This example suits the aforementioned second characteristic of a financial network component that is prone to generate a systemic effect on the whole network.

2. Why PERE Itself Poses No Direct Systemic Risks

Unlike banks, private equity real estate does not seem to suit any one of the three characteristics mentioned above. First, it constitutes a very small industry size in comparison to many other types of investment schemes, such as hedge funds and banks. PERE likely has less than one-tenth of the assets of the private equity industry as a whole, and a tiny fraction of the trillions of dollars in assets that banks possess.

Second, the financial connections between private equity real estate and markets are significantly weaker than, say, hedge funds and banks. Hedge funds have exposure to a wide variety of markets via derivatives transactions and their broad investment strategies, but PERE strategies are much narrower and they don’t do much with derivatives. Banks have inherent exposure to many markets via derivatives transactions and interbank lending, among other things.

In terms of synchronization, PERE has often desynchronized investment returns with other investment schemes. David Geltner, Norman G. Miller, Jim Clayton, and Piet Eichholtz observed stocks, real estate long-term bonds, and t-bills, concluding:

[T]he four major asset classes . . . do not all “move together” in their investment performance. That is, they do not always tend to all do well at the same time, or all do poorly at the same time. The correlation among their periodic returns is generally only moderately positive.

Therefore, it is unlikely that private equity real estate will pose systemic risks through its sheer industry size, its financial connections or the synchronization of its investment returns with other investment schemes’ returns across the markets.

43. Id. at 199.
44. Id.
45. See infra Part I.A.3.a.
3. Comparisons Between Hedge Funds And Private Equity Real Estate Funds

Private equity real estate funds are a type of “private funds,” meaning funds exempt from the Investment Company Act, just like hedge funds. It is important to compare hedge funds and private equity real estate funds, which are, in many respects, regulated similarly and thus tend to be seen by inexperienced financial or legal personnel as imposing the same level of risks, either on their investments or on the capital markets as a whole. It is worth noting that the risk of a particular type of investment is different from the risk it imposes on the whole financial system; the former is investment risk, and the latter is systemic risk.

Some view the enactment of the Dodd-Frank Act as not only a cure for poor mortgage lending practices but also as providing necessary preventative measures against any systemic risks posed by hedge funds, especially because a parallel could be drawn between bank systemic risk and the kind of risk posed by hedge funds. For example, in either instance, market shocks triggered institutional failures which in turn led, or could have led, to a chain of institutional and market failures. . . . Both also were transmitted through linkages in a chain of relationships: in bank systemic risk, the linkages are interbank borrowings and the interbank clearing system for payments; in LTCM, the linkages arose from its derivatives-based hedging strategy with other institutions, which, in turn, had linkages with yet other institutions and markets.47

Such a view is possibly further strengthened by additional explanations for why hedge funds might give rise to systemic risk: (1) derivatives trades, (2) the size of industry, (3) runs on prime brokers, (4) short selling, (5) usage of leverage, (6) illiquidity, (7) mortgage-backed securities exposure, and (8) lack of adequate information.48 Of course, not everyone agrees that hedge funds do give rise to systemic risks, but if they were to generate systemic risk concerns, the foregoing explains why they might do so.

But the same systemic risks concerns are not applicable to private equity real estate funds, which have a much smaller industry size, as well as far fewer financial connections and the absence of synchronization. Private equity real estate funds have several key structural differences from hedge funds.

47. Schwarze, supra note 9, at 201 (internal footnotes omitted).
a. Derivatives Trades

Compared to hedge funds, which many believe carry a large-size exposure to other institutions and market participants by virtue of their derivatives activities, the real estate derivatives market for private equity real estate is very slim in the United States.

Before the financial crisis,

In the U.K., (real estate) derivatives trading has been growing, with GBP 3.9 billion, or about $7.9 billion, in trades in the first six months of this year matching the total for all of 2006. In contrast, the U.S. market has struggled to take off. While there are no formal data, experts suggest that trades total in the hundreds of millions of dollars rather than billions. This is a tiny fraction of the notional value of U.S. total derivatives, which was estimated as $182.2 trillion in 2008. While it might be possible in the future that private equity real estate could be sufficiently exposed to derivatives, we are an extremely long way off from such an occurrence.

It should also be noted that Title VII of the Dodd-Frank Act subjects OTC derivatives (i.e., one counterparty faces another counterparty), “even hedges executed by non-financial end users,” to “regulatory oversight and new requirements.” That should plug the regulatory gap in derivatives. Title VII, combined with the very tiny size of the real derivatives market, makes it highly unlikely for private equity real estate to pose systemic risks.

49. See Schwarcz, supra note 9, at 203 (“In [Long-Term Capital Management], the potential for systemic risk existed not by reason of its intrinsic status as a hedge fund but by the sheer size of its exposure to other institutions and market participants.”).


52. Dodd-Frank’s Title VII — OTC Derivatives Reform: Important Answers for Board Members as Companies Begin the Road to Reform, ERNST & YOUNG 1, http://www.ey.com/Publication/vwLUAssets/Key_questions_board_members_should_ask_about_Title_IIIF/$FILE/Americas_FAAS_Dodd_Frank_derivatives_reform.pdf (last visited Oct. 20, 2013).
b. The Size of Industry

Given the small real estate derivatives market, the size of private equity real estate’s exposure to other institutions and market participants is most likely to be minimal. The small exposure of private equity real estate is further supported by the small industry size of private equity real estate compared to the size of hedge funds. As mentioned previously, as of the third quarter of 2013, there were “468 private equity real estate funds (targeting assets rather than other funds) seeking an aggregate of $154 [billion] in capital commitments.”

Compare that number to hedge funds. As of late 2012, “[g]lobal hedge funds now [oversaw] $2.2 trillion in assets. . . .” Even hedge funds as an industry represent a relatively small size. “As of September 30, 2010, the global mutual fund industry managed $23.7 trillion in assets, and the top 50 U.S. bank holding companies alone had $14.4 trillion in assets.”

In addition, hedge funds account for a very large percentage of trading activity in many markets. “A 2007 study found that hedge funds accounted for 25 to 60 percent of the turnover in the markets examined.” Private equity real estate, however, accounts for only a small percentage of transactions in the real estate markets. Even Public Real Estate Investment Trusts (“REITs”), which potentially carry a much bigger industry market capitalization (approximately $603.4153 billion in 2012) than private equity real estate, “control only a fraction of all commercial property investment. In real estate, it is not uncommon for individual or institutional investors to effectively own the underlying productive assets directly, with no corporate-level entity involved in the investment decision-making process.”

It is estimated that “[t]he [“pure-play”] real estate asset class total value [is] approximately $17 trillion . . . [including] residential as well as commercial property. . . .”

Therefore, the industry size of private equity real estate is quite small, compared to that of other types of industries and investment schemes. The small size of private equity real estate gauged from several different
perspectives suggests that it doesn’t generate systemic risks.

c. Use of Prime Brokers

Hedge funds may have contributed to systemic risk during 2008 partially because “hedge fund managers withdrew tens of billions of dollars in assets from prime brokers and their parent investment banks. These withdrawals were essentially a run on the bank, analogous to bank runs by individual depositors during the Great Depression, and contributed to the financial crisis.”\textsuperscript{60} “Prime brokers provide a centralized securities clearing facility, handle a hedge fund’s collateral, and may provide financing to hedge fund clients to facilitate trades.”\textsuperscript{61} However, not all believe that hedge funds contributed to significant losses at prime brokers. “[T]here is little indication that hedge fund losses led to significant losses at prime brokers and other creditors. It appears that prime brokers and other hedge fund creditors required adequate margin and collateral to protect themselves against hedge fund losses.”\textsuperscript{62}

It is also worth mentioning that:

The reforms go a long way in addressing factors that can lead to hedge fund runs on prime brokers. Dodd-Frank contains provisions that protect the margin that hedge funds post with prime brokers on their derivatives positions. A prime broker must segregate these assets from its own account for certain types of swaps and give a party the option of segregating the assets for others. These new provisions should reduce the incentives for hedge funds to withdraw funds from their prime brokers at the first sign of trouble.\textsuperscript{63}

In contrast to hedge funds, private equity real estate funds typically do not use prime brokers, so another potential avenue of systemic risk would not occur in the case of private equity real estate.

d. Short Selling

Short selling (or “shorting”) is a central part of many hedge fund investment strategies, and hedge fund shorting has been blamed for contributing to the financial crisis. The U.S. Securities and Exchange

\begin{footnotes}
\footnote{60. Dixon et al., supra note 48, at xviii.}
\footnote{62. Dixon et al., supra note 48, at xv-xvi.}
\footnote{63. \textit{Id.} at xx.}
\end{footnotes}
Commission’s (SEC’s) ban on shorting financial stocks between September 19 and October 8, 2008, indicates that at least some in government were concerned about the impact of short selling.\textsuperscript{64}

Concern remains that short selling by a large hedge fund or multiple hedge funds can result in an unjustified fall in stock prices or can cause a decline in the real value of the firm. The decline might be so rapid that there is no opportunity for the firm to dispel rumors about its financial health or for investors to provide additional capital before the firm collapses. Such collapses can pose a risk to the financial system and reduce the level of economic activity.\textsuperscript{65}

However, “[a]lthough some studies identify short selling as a significant contributor to the financial crisis, the bulk of research does not conclude that short selling played a major role.”\textsuperscript{66} Nonetheless, the Dodd-Frank Act does contain provisions to regulate short selling.

Whatever the merits of this position, private equity real estate funds invest the vast majority of their funds in real estate properties, for which there is no real short selling market. As Geltner et al. pointed out, “[i]n real estate, short sales are impossible in reality. . . .”\textsuperscript{67} While it is possible that private equity real estate funds might do some short selling of mortgage-backed securities, redirecting private equity real estate toward the non-(c)(1)/(c)(7) exemptions, several of which are aimed at funds that invest in non-securities and real estate investments, would generally limit the amount of mortgage-backed securities that a private equity real estate fund could invest in, and would consequently limit the amount of mortgage-backed securities short sales.

e. Usage of Leverage

“The use of debt to finance an equity investment creates what is called ‘leverage’ in the equity investment, because it allows equity investors to magnify the amount of underlying physical capital they control (which may also magnify the risk and return performance of the equity).”\textsuperscript{68} “Leverage affects the ex ante equity risk premium in just such a way that the benefit of the additional expected return is exactly offset by the cost of the additional risk, as evaluated by the capital market.”\textsuperscript{69}

King and Maier, who discussed the potential systemic risks posed by hedge fund leverage, explained:

\begin{itemize}
  \item \textsuperscript{64} \textit{Id.} at xvii.
  \item \textsuperscript{65} \textit{Id.} at xxi.
  \item \textsuperscript{66} \textit{Id.} at xvii.
  \item \textsuperscript{67} \textit{GELTNER ET AL., supra note 46, at 711, n.6.}
  \item \textsuperscript{68} \textit{Id.} at 287.
  \item \textsuperscript{69} \textit{Id.} at 296.
\end{itemize}
A direct channel occurs when a collapse of a hedge fund (or group of hedge funds) leads to forced liquidations of their positions at fire-sale prices. The impact on asset prices may be amplified through the use of leverage—whether created directly using margin or indirectly using derivatives. If the positions are large, relative to the liquidity of the asset, a disorderly unwinding could generate heavy losses to counterparties, and ultimately contribute to financial distress at one or more systematically important financial institutions.\footnote{70}{King & Maier, supra note 61, at 286.}

Their article further noted that “[i]n the indirect channel, forced hedge fund liquidation exacerbates market volatility and reduces liquidity in other financial markets, potentially leading to contagion.”\footnote{71}{Id.}

In contrast, the typical leverage used by private equity real estate funds is generally very moderate, which would decrease the risk of forced liquidations. Ernst and Young reports that in 2007, private equity real estate funds averaged leverage in the 65%-75% range, while their 2011 trend averaged leverage in the 60%-70% range.\footnote{72}{Trends Facing Real Estate Private Equity: Changes to Fund Structuring Terms, ERNST & YOUNG, http://www.ey.com/GL/en/Industries/Real-Estate/Trends-facing-real estate-private-equity—Changes-to-fund-structuring-terms (last visited Oct. 21, 2013) [hereinafter Changes to Fund Structuring Terms].}

In practice, though, many private equity real estate funds utilize even lower leverage than that. “Traditionally core investment funds employed little or no financial leverage, but by the 2000s they were often using modest amounts of debt, up to 20%-30% loan-to-value ratios (LTVs).”\footnote{73}{GELTNER ET AL., supra note 46, at 680.}

“Perhaps most significantly, the value-added style traditionally allows considerably more financial leverage than the core style, with typical LTVs in the neighborhood of 50 percent or slightly more. This is still conservative by the standards of many real estate investors . . . .”\footnote{74}{Id.}

In contrast, for hedge funds, one recent article noted that “hedge fund managers reported leverage of 3.4 [i.e. 340%], on average.”\footnote{75}{Katya Wachtel, Unstructured Finance: Hedge Funds Love Affair with Leverage Still on Hiatus, for Now, REUTERS (Oct. 5, 2012), http://blogs.reuters.com/unstructuredfinance/2012/10/05/hedge-funds-love-affair-with-leverage-still-on-hiatus-for-now.}

This said, Dixon et al. suggested that even hedge funds don’t necessarily even pose systemic risks on account of leverage: “[I]t appears that hedge funds typically have a much lower rate of leverage on average (two to three times leveraged) than other segments of the financial sector.
(investment banks are often leveraged between 14 and 40 times).”

Therefore, given that private equity real estate fund leverage is typically very moderate, it further supports the argument that private equity real estate doesn’t generate systemic risks.

f. Illiquidity

Recent academic research suggests that it is increasingly important to pay attention to the liquidity of hedge fund investments, and regulators should realize that, even if no one hedge fund may be large enough to pose a systemic risk to the financial system, negative shocks can cause hedge funds as a group to unwind their positions at the same time, with ramifications cascading through the economy.

In other words, the concern is that “the buildup of highly leveraged, illiquid hedge fund portfolios and massive deleveraging when prime brokers or investors withdraw credit and capital in response to a financial shock.” As noted above, “If the positions are large, relative to the liquidity of the asset, a disorderly unwinding could generate heavy losses to counterparties, and ultimately contribute to financial distress at one or more systematically important financial institutions.”

Although private equity real estate investments may also be illiquid, meaning that they might be difficult to easily sell without a substantial loss in value, given the tiny size of the industry, and the fact that it accounts for only a fraction of the activities that occur in the real estate markets, it is highly unlikely that the illiquidity of its investments would pose systemic risks. As discussed in the introduction, the weak financial connection and absence of synchronization would also support the argument that private equity real estate doesn’t generate systemic risks.

g. Mortgage-Backed Securities

Some argue that hedge funds give rise to systemic concerns because “hedge funds invested in the mortgage-backed securities (“MBS”) and collateralized debt obligations (“CDO’s) that contributed to the buildup of the housing bubble.” However, others also argue that hedge funds did not contribute to systemic risks in this respect:

[B]y shorting subprime mortgages and banks that were heavily

76. Dodd-Frank: The Road Ahead, supra note 25, at 2.
77. Dixon et al., supra note 48, at xxiii.
78. Id. at xxv.
79. King & Maier, supra note 61, at 286.
80. Dixon et al., supra note 48, at xvi.
exposed to subprime debt, hedge funds called attention to the growing bubble. They also provided funds to this market at the trough of the crash, possibly limiting further declines. In light of these opposing factors, no strong case can be made that hedge funds were a significant contributor to the financial crisis through the buildup of the housing bubble.  

Whatever the merits of the above arguments, despite the possibility of private equity real estate funds investing in mortgages and mortgage-backed securities, it is highly improbable that private equity real estate would lead to systemic risk by virtue of its investments in mortgages and mortgage-backed securities. This is because the Dodd-Frank Act should cure any problems with poor mortgage lending practices and the resulting problems with mortgage-backed securities. In addition, by redirecting private equity real estate funds toward non-\((c)\)(1)/(c)(7) exemptions, several of which are aimed at funds that invest in non-securities and real estate, it would further limit the ability of private equity real estate to become involved in mortgage-backed securities. Finally, it’s unusual for private equity real estate funds to focus on investing in mortgages and mortgage-backed securities. Instead, the vast majority of their investments are in various types of real properties.

h. Lack of Information

“Following the LTCM collapse and during the financial crisis, regulators complained about the lack of transparency in hedge fund positions, leverage, and asset valuation and were frustrated by their inability to collect data on hedge funds.”\(^8\) Form PF “aggressively addresses gaps in the information available to regulators on hedge fund operations, investment strategies, and investment positions. The legislation will also result in far more information being available on derivatives trades, trades that were at the heart of the financial crisis, and short sales.”\(^9\) The regulators have already finalized Form PF, and they haven’t sought to apply it against private equity real estate. As shown above, private equity real estate doesn’t engage in many derivatives trades, and engages in no short sales. Further, as demonstrated through all the evidence presented above, private equity real estate doesn’t generate systemic risks. Therefore, a lack of information concern doesn’t apply to private equity real estate.

i. Summary of Comparisons Between Hedge Funds and Private

\(^{8}\) Id.
\(^{9}\) Id. at xviii-xix.
Equity Real Estate Funds

The table below summarizes the key differences between the two types of funds, in terms of the systemic risk concerns of either fund. It is worth noting that the systemic risk concerns of hedge funds don’t necessarily indicate that they really do give rise to systemic risks, but only reflect some scholarly opinions that they may raise concerns about such potential risks.

<table>
<thead>
<tr>
<th></th>
<th>HEDGE FUNDS (HF)</th>
<th>PRIVATE EQUITY REAL ESTATE FUNDS (PEREF)</th>
<th>SYSTEMIC RISK CONCERNS</th>
<th>RISK CONCERNS</th>
</tr>
</thead>
<tbody>
<tr>
<td>SIZE OF INDUSTRY</td>
<td>Relatively Large (~2.2 trillion)⁸⁴</td>
<td>Relatively Small (~$154 billion)⁸⁵</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>DERIVATIVES MARKET</td>
<td>25-60%⁸⁶</td>
<td>Very Small⁸⁷</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>USE OF PRIME BROKERS</td>
<td>Relatively Large Exposure</td>
<td>Tiny Exposure</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>SHORT SELLING</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>USE OF LEVERAGE</td>
<td>Moderate to High (Average is ~340%)⁸⁸</td>
<td>Low to Moderate (Average is ~60-70%)⁸⁹</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>ILLIQUIDITY</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Unlikely⁹⁰</td>
</tr>
</tbody>
</table>

⁸⁴. Herbst-Bayliss, supra note 54.
⁸⁵. Mather, supra note 5.
⁸⁶. Dixon et al., supra note 48.
⁸⁷. Even for REITs, which are a type of public real estate investment trusts that potentially carries a much bigger industry market capitalization (approximately $603.4153 billion in 2012) than private equity real estate, according to Geltner, “REITs control only a fraction of all commercial property investment. In real estate, it is not uncommon for individual or institutional investors to effectively own the underlying productive assets directly, with no corporate-level entity involved in the investment decision-making process.” Geltner et al., supra note 46, at 287. Geltner, et al. estimate that “[t]he [“pure-play”] real estate asset class total value [is] approximately $17 trillion … [including] residential as well as commercial property.…” Id. at 136.
⁸⁸. Wachtel, supra note 75.
⁸⁹. Changes to Fund Structuring Terms, supra note 72.
⁹⁰. Due to small size, lack of connections and no synchronization.
We have just shown that PERE itself poses no direct systemic risk concerns. Let’s now do the following thought experiment. Suppose that the markets are a body of water, which consists of streams, rivers, lakes, seas and oceans, and suppose that the banks are rivers feeding into the seas and oceans, and that PERE is a stream. We already know that the stream itself has minimal effects on the whole water body, and therefore must not be directly connected with the big oceans in any major way. But still, even though the stream doesn’t join the oceans by itself, the stream is still connected to the rivers, which feed into the seas and oceans. Thus, although PERE itself poses no systemic risk concerns, could banking investments in PERE induce failures of banks, which would in turn give rise to a different form of systemic risk?

Let’s consider a flow chart that demonstrates our problem at hand:

Economy ↔ Market ↔ Banks ↔ PERE ↔ Real Estate Investments

As we mentioned earlier, because of the strong connections between banks and various other financial entities in the markets, banks carry inherent systemic risks. If we were to determine the possibility of a risk “ripple effect” across the flow chart illustrated above, namely, the back propagation of banks’ inherent risks through the market via potential contributing factors of PERE, what would be the factors we considered?

Obviously, the inherent risks of PERE investments could potentially feed backward to the banks and propagate along the whole chain of the financial markets. Most comfortingly, thus far our analysis of systemic risks has ruled out any direct systemic risk concerns of PERE itself. But what about the investment risks of such funds, which conduct real estate investments?

Last, but not least, recall one of the points in the legislative history of the Volcker Rule, which concerns the prohibitive effect of the Volcker Rule to “reduce the scale, complexity, and interconnectedness of those banks that . . . have hedge fund or private equity exposure.”91 What are the

nature and strength of PERE’s connection with the banks? In the ensuing subsections, we will examine these factors, one by one.

5. The Typically Moderate Investment Risks of Private Equity Real Estate.

The portfolio of each PERE fund varies from case to case, but in general, most PERE funds largely invest in operational real estate (including improvement properties), and then moderately in land. However, many types of PERE funds don’t invest in land at all. The local investment risks of these real estate investments are examined below.

6. Risk Assessment of Real Estate Investments

One point that greatly favors real estate as an investment target is that, like most investments that carry a cyclical characteristic, it is historically an investment with a low to moderate risk profile in comparison with many other types of investments. A book entitled Commercial Real Estate Analysis and Investments provides a table on the stereotypical characterization of major investment asset classes.

<table>
<thead>
<tr>
<th>INVESTMENT CONCERN</th>
<th>STOCKS</th>
<th>REAL ESTATE*</th>
<th>LONG-TERM BONDS**</th>
<th>CASH(T-BILLS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk</td>
<td>High</td>
<td>Moderate to Low***</td>
<td>Moderate to Low***</td>
<td>Lowest</td>
</tr>
<tr>
<td>Total Return</td>
<td>High</td>
<td>Moderate</td>
<td>Moderate</td>
<td>Lowest</td>
</tr>
<tr>
<td>Current Yield</td>
<td>Low</td>
<td>High</td>
<td>Highest</td>
<td>Moderate</td>
</tr>
<tr>
<td>Growth</td>
<td>High</td>
<td>Low</td>
<td>None</td>
<td>None****</td>
</tr>
<tr>
<td>Inflation Protection</td>
<td>LR. Good</td>
<td>Good</td>
<td>Bad</td>
<td>Best (if reinvested)</td>
</tr>
</tbody>
</table>

* Unlevered institutional quality commercial property (fully operational, “stabilized”).
** Investment grade corporate or government bonds.
*** Low risk for investors with long-term horizons and deep pockets, so they can hold the assets to maturity or until prices are favorable. Moderate risk for investors fully exposed to asset market price volatility.
**** Unless the investment is rolled over (reinvested), in which case there is no current yield.\(^92\)

The authors of this book go on to note:

\(^92\) GELTNER ET AL., supra note 46, at 137.
In the risk and return dimensions, unlevered investment in real estate tends to fall between stocks at one extreme and cash (or short-term bonds such as T-bills) at the other extreme. In this regard, real estate is much like long-term bonds. Unlike bonds, however, real estate provides some capital growth and relatively good inflation protection.93

In addition, this table demonstrates that an asset class with low to moderate risks, fully operational unlevered institutional quality commercial property real estate offers an excellent combination of total return and current yield.

The authors of the book make an additional observation: They studied both the average annual total return from 1970-2010 as well as the annual volatility from 1970-2010 and noted that real estate had approximately an 11% annual volatility level, while stocks had approximately an 18% annual volatility level.94 The authors note that volatility “is a basic way to measure the risk in an investment, because it indicates the range of variability in the investment performance outcomes across time.”95 On the side of the average annual total return, real estate had approximately a 10% return level, while stocks had an approximately 12% return level.96 While stocks exhibited volatility that was approximately 63.64% greater than real estate, they only appeared to generate returns that were 20% greater.97 That suggests that real estate likely delivers excellent risk-adjusted returns.

Of course, the chart discussed above evaluates the characteristics of real estate on an unlevered basis. But even in the leveraged case, the fact that PERE typically uses moderate leverage keeps the risks of leverage relatively moderate. The observation that PERE funds averaged leverage in the 60-70% range in 2011,98 combined with the generally low volatility of the real estate markets, suggests only a moderate risk of leveraged assets for PERE investors. The architects of the Volcker Rule were likely concerned about the amount of leverage used by hedge funds.99 One article noted that Long Term Capital Management (“LTCM”), a hedge fund that collapsed during the late 1990s, “had borrowed . . . a leverage factor of

93. Id.
94. Id.
95. Id.
96. Id.
97. Id.
98. Changes to Fund Structuring Terms, supra note 72.
al%201%2018%2011%20org.pdf.
Of course, today hedge funds don’t typically borrow at that level. One recent article noted that “hedge fund managers reported leverage of 3.4, on average.”\textsuperscript{101} It is therefore apparent that even the most leveraged variety of PERE funds are typically much less leveraged than hedge funds.

Furthermore, when the volatility of PERE investments is computed with the consideration of leverage, leverage appears to increase the volatilities of PERE funds by a moderate amount. For example, when a side-by-side comparison was made between the cumulative total returns (income plus capital appreciation) from 2000 through early 2012 as tracked by the NCREIF Property Index (NPI)\textsuperscript{102} and by two institutional investor fund-level indices published by NCREIF in cooperation with the Townsend Group (an institutional investment consultancy),\textsuperscript{103} the NPI had quarterly volatility of 2.9%, the core funds index had quarterly volatility of 4.0% and the value-added funds index had quarterly volatility of 5.6%.\textsuperscript{104} This suggests that even compared to the unlevered commercial property investments, private equity real estate funds carry only moderately higher risks. Given all this, one may view PERE as a relatively safe investment tool, even with the consideration of leverage.\textsuperscript{105}

The chart also only evaluates the investment characteristics of institutional quality commercial property, rather than other types of real estate investments. Many private equity real estate funds invest in institutional quality commercial property, but some may invest in land or properties to be improved, which not only is riskier, but also carries the potential for greater returns that are commensurate with the additional risks. As noted above, value-added funds, which invest in some property improvements, still exhibit moderate volatility.

Land as an investment class is considerably riskier than other types of naked real estate investments. Under the call option model of land value, “land is viewed as obtaining its value through the option it gives its owner

\begin{itemize}
\item \textsuperscript{100} Alison K. Gary, \textit{Creating a Future Economic Crisis: Political Failure and the Loopholes of the Volcker Rule}, 90 \textit{Or. L. Rev.} 1339, 1380 (2012) (internal citation omitted).
\item \textsuperscript{101} Wachtel, \textit{supra} note 75.
\item \textsuperscript{102} The NCREIF Property Index (NPI), available at http://www.ncreif.org/property-index-returns.aspx, is a quarterly time series composite total rate of return measure of investment performance of a very large pool of individual commercial real estate properties (unlevered) acquired in the private market for investment purposes only.
\item \textsuperscript{103} Unlike the NPI index, the NCREIF / Townsend indices are private equity real estate fund-level indices, which exemplify an “attempt to track the performance actually realized by investors in funds that invest in properties, rather than the performance achieved directly by the underlying properties.” \textit{Geltner et al.}, \textit{supra} note 46, at 679.
\item \textsuperscript{104} \textit{Id.} at 680.
\item \textsuperscript{105} Occasionally, a private equity real estate fund could use higher leverage that raises the investment risks, but the industry doesn’t trend in that direction.
\end{itemize}
to develop a structure on the land. The land owner can obtain a valuable rent-paying asset upon the payment of the construction cost necessary to build the structure.”\textsuperscript{106} It’s worth noting that land effectively adds leverage to the funds’ investments. When investing in land, the portfolio of investments includes a long position in the underlying real estate asset (the forward commitment) and a short position in the construction costs (the leverage). The combination of short and long cash flows is inherently levered because the cash outflows do not occur at the same time and because the construction costs are not perfectly and positively correlated with the value of the underlying asset.\textsuperscript{107}

Although land effectively adds leverage, “the option enables the landowner to avoid much of the negative consequences of the downside outcome of future market volatility, while still retaining the ability to profit from the upside.”\textsuperscript{108} Nonetheless, land has a risky side to it, since the decision to hold off on developing the land involves risks about what the future might bring. The value of the land option depends very sensitively on the difference between the construction costs and the value of what can be built. “As investments, call options are much more risky than their underlying assets (in this case, the usage value of the built property), and hence require a much higher expected return.”\textsuperscript{109}

Despite the fact that land investments might significantly increase the risks of PERE, a footnote in the above chart noted that real estate is lower risk “for investors with long-term horizons and deep pockets, so they can hold the assets to maturity or until prices are favorable.”\textsuperscript{110} This is auspicious news for PERE, since PERE usually does have long-term investment horizons.\textsuperscript{111} The long-term horizon of PERE will clearly help offset short-term real estate market fluctuations, and therefore help ease the risks of land investments, even though land investments are still relatively risky. Keep in mind, however, that many types of PERE funds have nothing to do with land investments.

Another point worth noting is that Dodd-Frank requires banks to develop in-depth internal ratings methodologies to assess investment risk. As a result, regulators and boards will likely have higher expectations for the investment due diligence

\textsuperscript{106} GELTNER ET AL., supra note 46, at 707.
\textsuperscript{107} Id. at 96.
\textsuperscript{108} Id. at 137.
\textsuperscript{109} Id. at 96.
\textsuperscript{110} Id. at 709.
\textsuperscript{111} Id. at 707.
processes banks and their external service provides have in place. Banks without the resources to develop these internal processes may be forced to significantly limit their investment opportunity set, possibly limiting earnings and diversification potential in the securities portfolio.112

As a result, there is every reason to expect that banks will be reasonable about limiting their investments in PERE with higher investment risk profiles.

During the financial crisis of 2008, it is highly likely that mortgage-backed securities were even more toxic as an asset class than real estate itself. During the crisis, banks had many trillions of dollars in exposure to toxic mortgage assets. In contrast, the PERE industry focuses primarily on operating and developing real properties, and not on investing in mortgage-backed securities. Furthermore, banks already have so much exposure to mortgage-backed securities that it is highly improbable that any secondary exposure from rare types of PERE funds would “tip the scales” and raise systemic risk concerns.

There is more favorable news for PERE. One of the investments that arguably made hedge funds high risk was derivatives. For PERE, the real estate derivatives market is currently very slim in the United States. While there is no formal data, experts suggest that trades total in the hundreds of millions of dollars rather than billions.113 This is obviously an extremely tiny fraction of the notional value of U.S. total derivatives, which was estimated to be $182.2 trillion in 2008.114

Another source of risk for hedge funds that makes them very risky is short selling. “In real estate, short sales are impossible in reality . . . .”115 That fact is also comforting.

Some naysayers might argue that the financial crisis of 2008 was caused by the fact that banks were exposed to real estate investments. However, while real estate did suffer a particularly sharp decline after the financial crisis of 2008, that was an anomalous drop. No other real estate crises since 1969 resulted in a drop of an even remotely comparable magnitude. Figure 1 below shows the history of U.S. commercial real estate from December 1969 until December 2009.

113. Dover, supra note 50.
114. OFFICE OF THE COMPTROLLER, supra note 51.
115. GELTNER ET AL., supra note 46, at 711.
More importantly, the sharp decline in the real estate markets after the 2008 financial crisis was caused primarily by poor mortgage lending practices, which had both induced the real estate bubble and then burst it. But the inauguration of the Dodd-Frank Act was intended to solve the root of these problems. If the Dodd-Frank succeeds in its goals, in light of the history of real estate as an asset class and its characteristically low volatility, there is no reason to anticipate real estate will perform inconsistently with its historical characteristics. However, if by any chance, the sweeping financial legislation suffers from an incomplete success and the nation encounters another large-scale market crash, it would be extremely difficult to envision real estate investment as the leading culprit of the potential crisis, given the fact that it wasn’t real estate investment itself but poor mortgage lending practices that triggered the 2008 financial crisis and that real estate has typically been one of the lower risk investment types in the nation’s financial history. Keep in mind that if there were ever a future real estate crisis, banks would suffer great exposure to real estate risks via their mortgage practices, and any secondary exposure to real estate from PERE would be minimal. Thus, the regulators should focus on the root of the problem, toxic mortgages, and avoid over-regulating PERE.
7. The Interconnectedness of Banks with PERE Funds and Other Investment Schemes

Given the scope and magnitude of banks’ connections with other financial institutions as well as investment schemes, the connection between banks and PERE, depending on its strength, could potentially exaggerate the risks of PERE through bank’s multi-channeled connections with the whole financial market. But would such a connection be so strong that systemic risks could stem from such a typically moderate-risk investment scheme as PERE, or even from a higher risk investment scheme if a PERE fund were to invest in land?

In order to answer this question, we will first inspect the percentage of banks’ investments in PERE relative to their whole investment portfolio, and then examine the fund contributions of banks to PERE.

Overall, much evidence supports that BHCs are not too heavily invested in PERE. First of all, below is a pie chart (Fig. 2) that illustrates the distribution of various investment targets in BHC investment portfolios. BHC investment portfolios, as of the end of 2011, accounted for $2.85 trillion, which amounted to 21% of BHC total assets.116

116. Callin & Ayre, supra note 112.
FIGURE 2. The distribution of investment targets in banks’ investment portfolios

As the reader can see, 8% of banks’ investment portfolios are exposed to non-agency mortgage-backed securities, which aren’t guaranteed. That gives banks exposure to real estate, regardless of their exposure to PERE. Outside of their investments, banks are also very often exposed to real estate through their mortgage lending practices. In addition, banks invest 3% of their portfolios in corporations and 10% of their portfolios in foreign securities. Among all types of investment activities of banks, PERE is by no means the “frontrunner” of all others.

Secondly, out of the “1% Other” banking investments shown above, only a small fraction of it has been invested in PERE. Preqin has noted that “[b]anks accounted for 11% ($115bn) of the total capital invested in private equity funds in 2008, whereas this figure fell to 8% ($110bn) in 2011.”

This figure accounts for banking investments in all types of private equity funds. The PERE industry is significantly smaller than the private equity industry. Bain Capital recently noted that in 2012, the global private equity industry had “[a]lmost $2 trillion worth of assets on general partners’ books . . .”

One article notes that, as of Q3 2013, there were “468 private equity real estate funds (targeting assets rather than other funds) seeking an aggregate of $154 [billion] in capital commitments.” Thus, it appears that the aggregate size of PERE is less than 10% of the aggregate size of private equity as a whole. In turn, that suggests that if banks have $110 billion invested in private equity, they may only have as little as $10 billion invested in PERE. Given that the investment assets of BHCs are likely around $2.85 trillion, that means that PERE may likely constitute as little as one-third of one percent of the investment assets of banks. As a result, the connections between banks and PERE are very weak, and thus the potential for systemic risk is very low.

Compare this figure to the level of banks’ exposure to mortgage loans and mortgage-backed securities. Clearly, banks had and continue to have trillions and trillions of dollars in combined mortgage and MBS exposure. Banks as of 2012 had “two and a half trillion dollars in residential mortgage exposure” alone on its balance sheets. In 2009, “banks and

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119. Mather, supra note 5.
120. Examining the Impact of the Proposed Rules to Implement Basel III Capital Standards: Hearing Before the Subcomm. on Insurance, Housing & Community
thrifts [held] about $1.7 trillion of commercial mortgages.” Commercial banks as of 2011 had $1.3 trillion in MBS exposure as well. Another article noted that banks probably lost “around half a trillion dollars” on “subprime mortgages.” Thus, banks were exposed to various mortgage dangers in an amount which exceeded banks’ exposure to PERE by a great many orders of magnitude.

Currently banking investments in PERE is very low, but will this trend change over time, if regulations remain lenient? The answer is that it is unlikely. First off, as discussed above, banks in 2008 only invested $115 billion in private equity funds as a whole. There is every reason to think that, in spite of the Volcker Rule, banks will continue to allocate their private equity investments to a certain amount of non-real estate private equity, since the Volcker Rule contains a quite generous de minimis carve-out on banking investments in non-real estate private equity. Because of that carve-out, the connections between banks (the river) and traditional private equity funds (other streams) aren’t dammed, so there’s no reason to expect that the upstream waters from all the banking funds previously allocated to private equity funds would flood into PERE.

Thus, even in the unlikely event that PERE went up from one-third of one percent to, say, hypothetically, one percent of banking investments, that still wouldn’t be a large enough exposure to create systemic risk concerns.

Moreover, it’s important to remember that if banks were prohibited from investing in PERE, they would delegate their extra funds to other investment revenues, which most likely carry equal levels of investment risks as PERE, if not greater. As we know from the experiences of water navigations, when damming one watercourse downstream, the upstream stretch of water would reroute and flow into different brooks or rivers, which could carry flood risks themselves. Therefore it’s important to study the whole map of tributaries and understand the risks of all alternative waterways before plugging the connection between the estuary and a particular stream, if such a measure is absolutely necessary. However, in the case of PERE, as we discussed earlier, it poses no systemic risks and typically only moderate investment risks. Accordingly, from a regulatory perspective, there is no reason to believe that other choices of banking

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investment targets, which take up much bigger proportions of banking funds, carry less investment risks than PERE and should be placed as more optimal investment options than PERE.

In conclusion, banks investing in PERE might create some interconnectedness between banks and PERE, but this interconnectedness, in light of the small percentage of PERE investment relative to the banks’ whole investment portfolio and the insubstantial capital contribution of banks to PERE, should not give rise to systemic risk concerns. Furthermore, it’s unlikely for these connections to become strengthened in the future.

8. Conflicts of Interest

Besides preventing systemic risk problems, the Volcker Rule sought to avoid conflicts of interest between banks and their clients. Even if banks are not permitted to sponsor their own PERE funds, they might still have conflicts of interest when placing clients funds with outside PERE. For example, a bank could have any number of relationships with outside PERE funds, which might cause a bank to suffer from a conflict of interest when placing client funds. Furthermore, conflicts of interest in the securities context are a prevalent phenomenon in the market. Although the solutions for this problem vary from case to case, the general principle from a regulatory viewpoint is not to eliminate the financial activity that entails conflicts of interest, but to disclose the conflicts to the parties involved, so that both the financial freedom of the institutions and the customers’ rights could be protected.

Given that the Volcker Rule presents over-regulation dangers for PERE, the better solution would be to require banks to disclose their conflicts of interest, especially considering the minimal systemic risk concerns of banking investments in PERE.

9. The Dangers of Too Quickly Concluding that Private Equity Real Estate Funds Give Rise to System Risk Concerns

Discretion should be exercised in deciding whether there are systemic risks. It is important to understand that normal market swings do not translate into systemic risk. Rather, normal market swings are an example of “systematic risk.” Obviously, private equity real estate investments will be subject to normal market swings, but that doesn’t

124. Schwarcz, supra note 9, at 204.
translate into systemic risk. Schwarcz cautioned that “it is important not to
constrain market freedom in ways that deter systematic risk, which
facilitates market equilibrium and curbs excessive interest rates or periods
of inflation.”125 He also cautioned that systemic risk “is an economic, not a
political definition.”126 Thus, one must take care not to conclude too
quickly that private equity real estate may give rise to systemic risk
concerns for political reasons, as some might be inclined to do in the face
of a heightened state of alert.

10. The Regulator’s Perspective

It is highly likely that the SEC agrees with the view that private equity
real estate doesn’t generate systemic risks. The fact that the SEC recently
finalized Form PF, but did not require private equity real estate advisers to
file Form PF, is a strong indication that the regulators don’t believe that
private equity real estate poses systemic risks. It is also promising, as
discussed above, that the joint agencies in their proposed rule didn’t plan to
apply the Volcker Rule against private equity real estate advisers utilizing
non-(c)(1)/(c)(7) exemptions.

II. THE ABILITY OF A PRIVATE EQUITY REAL ESTATE ADVISER TO
SIDESTEP THE ADVISERS ACT

The Advisers Act, as amended by the Dodd-Frank Act, exposes many
“investment advisers” within the meaning of the statute to registration and
regulation under the Advisers Act. Private equity advisers who are
mandated to register under the Advisers Act may feel overburdened by the
requirement to file a public disclosure document, Form ADV, with the
SEC. Part 1 of Form ADV, among other things, requires registered
investment advisers to disclose information about the number of their
employees, the number and types of their clients, compensation structures,
assets under management, types of advisory services provided, the scope of
business activities in which the adviser engages, financial industry
affiliations, conflicts of interest, custody, control persons, and disciplinary
history. Part 2 of Form ADV, among other things, requires information
about services provided, fees, portfolio manager selection and evaluation,
information about clients provided to portfolio managers, restrictions on
clients’ ability to contact portfolio managers, information about the

125. Id.
126. Id.
background, business activities and conflicts of interest of supervised persons (officers, partners, directors and employees).  

Private equity advisers who are mandated to register may also likely have concerns about being subject to the full scope of regulation as registered “investment advisers” under the Advisers Act, which will impose compliance and administrative costs on their operations. The regulations under the Advisers Act are complex enough that private equity real estate advisers would have to invest in considerable compliance resources in order to be in a position to comply, which might burden their operations, especially for private equity real estate advisers that are not very large. For example, as mentioned in the introduction, a small fund delegated eight to ten of their total 140 employees to work full time on regulatory compliance. This is problematic from the perspective of the society as well. Scholars have noted that regulations are currently so complex and numerous that society is generally inundated with a great deal of good faith non-compliance.

The Advisers Act defines an “investment adviser,” subject to certain exceptions, 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 . . .”

The SEC staff “has traditionally taken an expansive view of what activities” 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.” A person could potentially qualify as an investment adviser even though giving investment advice is not his primary or even major business activity. In determining whether a person is an investment adviser, “the SEC staff looks at all the circumstances surrounding a person’s

128. Dodd-Frank: The Road Ahead, supra note 25.
129. See J.B. Ruhl and James Salzman, Mozart and the Red Queen: The Problem of Regulatory Accretion in the Administrative State, 91 GEO. L.J. 757, 766-768 (2003) (noting that “the sheer number or mass of rules” may hinder compliance and that “‘good faith noncompliance’ does indeed incur . . .”).
131. See THOMAS P. LEMKE & GERALD T. LINS, REGULATION OF INVESTMENT ADVISERS § 1:3 (Westlaw 2013).
132. Id. § 1:5.
133. Id.
134. Id.
activities,"\[
\text{including, without limitation, the following factors: "whether the person represents or otherwise holds himself out to the public as an investment adviser . . . whether the person receives compensation for rendering investment advice . . . [and] the frequency or regularity of the investment advice given."}^{136}
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“Security” is defined under the Advisers Act 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.\[
\text{What is a security under the Advisers Act can also be ascertained from relevant case law and SEC staff no-action letter positions. A private equity real estate investment adviser who advises about “securities” is usually considered to be in the business of providing investment advice and is therefore an “investment adviser” within the meaning of the Advisers Act. That is why private equity real estate investment advisers may seek to sidestep the Advisers Act by advising their funds only about real estate investments that are not “securities.” As discussed in the introduction, this sidestepping would likely also allow the funds they advised to bypass the Investment Company Act and the Volcker Rule, since these types of funds wouldn’t likely be “investment companies” within the meaning of the Investment Company Act. However, private equity real estate 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 real estate investments could potentially be “securities.”}^{138}
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On the other hand, as noted in the introduction, most types of private equity real estate

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135. Id.
138. See infra notes 164–243 and accompanying text.
funds really do seek to invest in operating and developing real properties, and not on securities investments. Below, this section explains how some of the most common real estate investments could potentially fall within the meaning of “securities” under the Advisers Act.
A. Investments in Traditional Real Estate Investments

Real estate advisers will generally not be considered to advise persons or entities about investing in “securities” if they advise them about investing in traditional real estate investments.

An offer of real estate without any collateral arrangements with the seller or others does not involve the offer of a security. . . . Accordingly, interests in an apartment cooperative, even if in the form of stock, or in a residential condominium normally will not be securities. As is usually the case, substance governs rather than form; that is, just as some things that look like real estate are securities, some things that look like securities are real estate. Similarly, the sale of commercial realty normally will not be viewed as a security if the purchaser directly retains control over the property and is not reliant on the efforts of others.139

However, even with traditional real estate investments, there is always a risk that they can become securities.

B. Investment in Stock

If real estate advisers advise about investing in corporate stock, they would likely be advising about securities, since the definition of “security” under Section 202(a)(18) of the Advisers Act includes “stock.”140 In the event a real estate investment adviser invests in a corporation, the general rule, as established in United Housing Foundation v. Forman, is that “stock” is considered a “security” if it has the major characteristics of stock: “dividends conditioned on an apportionment of profits, subjection to pledge, voting rights proportional to number of shares owned, and possibility of appreciation in value.”141 As Loss et al. note,

The subsequent Supreme Court decision in Landreth Timber Company v. Lambreth[sic] added that, when stock possesses “all of the characteristics we identified in Forman as traditionally associated with common stock . . . , the plain meaning of the statutory definition mandates that the stock be treated as

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141. LOSS ET AL., supra note 139, § 3-A-1 (e)(i), at 1,014.
‘securities’ subject to the coverage of the Acts.”

“The investment contract analysis of an instrument bearing the label stock is thus appropriate only when the ‘stock’ bears none or few of the characteristics usually associated with traditional stock.” When stock does not have these characteristics, the Supreme Court has employed the “investment contract” approach, which usually results in a finding that there is no security if the instrument involves no horizontal or vertical commonality.

C. Investments in Investment Contracts.

Real estate interests have also been held to be “securities” under the investment contract theory if the conditions of an investment contract apply. In SEC v. W. J. Howey & Co., the Supreme Court held that the elements of an investment contract are: (1) an investment of money; (2) in a common enterprise; (3) when a person is led to expect profits; (4) solely from the efforts of others. In that quintessential investment contract case, the Supreme Court concluded that “an offering of units of a citrus grove development coupled with a contract for cultivating, marketing and remitting the net proceeds to the investor” was an “investment contract.” Howey reveals how certain types of real estate investments could be deemed “securities.” Professor Paredes notes that an investment of money within the meaning of Howey merely means that “the purchaser gave up some tangible and definable consideration in return for an interest that had substantially the characteristics of a security.”

In order to determine for the purpose of the “investment contract” whether there is a “common enterprise,” “subsequent lower court[s] . . . have focused on whether a common enterprise involves horizontal commonality . . . or vertical commonality. . . .” The Third, Sixth and Seventh Circuits . . . subscribe[] to the horizontal commonality

142. Id. at 1,015-16.
143. Id. at 1,016.
144. See generally SEC v. W. J. Howey & Co., 328 U.S. 293, 298-99 (1946) (noting that an “investment contract” is 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 . . .”).
145. See, e.g., id. at 293 (holding that a share of ownership in a real estate development meets the conditions of an “investment contract” and therefore qualifies as “securities”).
146. Id. at 301.
147. Id. at 293-94.
149. Id. § 3-A-1(d)(i)(2), at 930-31.
approach.” Under this approach, courts will usually not conclude that there is an “investment contract” without pooling of investor funds. Paredes takes the view that a strict horizontal commonality approach “would not reach instances in which investors . . . invest in individual property . . . along with a management, development, or marketing contract.” In addition, Paredes notes that horizontal commonality may not reach a limited partnership with only a single investor, since there would be no pooling. Thus, it is possible that certain types of real estate investments could be structured to avoid this view of horizontal commonality.

According to the Fifth and the Eleventh Circuits, vertical commonality hinges on whether the “fortunes of all investors [are] dependent upon the promoter’s expertise.” Paredes notes that under this view of vertical commonality, “[u]nless two or more persons in some sense share in the profitability of an undertaking, it is difficult to argue that there is a common enterprise.” Thus, it is possible that certain types of real estate investments could be structured to avoid this view of vertical commonality.

In the Ninth Circuit’s view, vertical commonality should be more restrictively defined as one in which the “fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties.” Professor Paredes notes that the Ninth Circuit’s view “will embrace common enterprises both of a horizontal and of a vertical type whenever some form of profit sharing can be shown.” He continues:

Thus, when two or more investors pool their resources, there would be a common enterprise even if the promoter did no more than receive a broker's commission. Or when the income of one investor and one promoter was each dependent upon the profits of an undertaking, there would be a common enterprise. Under this approach, a conventional discretionary commodities account would not involve an investment contract if the broker only received commissions, but profit sharing by a broker in a discretionary account would create a security, as would profit sharing by a single promoter and a single investor in a

150. Id. at 932.
151. See id. (providing examples supporting this principle).
152. Id. at 933-34.
153. Id.
154. Id. at 934.
155. Id. at 936.
156. Id.
157. Id. at 937.
partnership, franchise arrangement, or pyramid scheme.\textsuperscript{158}

Under the Ninth Circuit’s view, it is more difficult to structure certain types of real estate investments to avoid the common enterprise requirement of \textit{Howey}.

In \textit{Forman},\textsuperscript{159} the Supreme Court analyzed whether there was a reasonable expectation of profits for “investment contract” purposes.\textsuperscript{160} The \textit{Forman} Court explained:

[b]y profits, the Court has meant either capital appreciation resulting from the development of the initial investment, as in \textit{Joiner} . . . or a participation in earnings resulting from the use of investors’ funds, as in \textit{Tcherepnin v. Knight} . . . (dividends on the investment based on savings and loan association's profits).\textsuperscript{161}

Today, the requirement that profits come solely from the efforts of others should not be read literally with respect to the “investment contract” analysis.\textsuperscript{162} Instead, the prevailing 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.”\textsuperscript{163}

The above discussion of investment contracts is only a preliminary and general analysis of the considerations involved in determining whether a particular investment is an investment contract. Needless to say, any number of circumstances could cause real estate to be considered an investment contract, and therefore a security. Below, this section discusses a few of the most common investment contracts issues that pertain to real estate interests.

\textit{D. Investments in Wholly Owned Entities.}

Real estate advisers could advise about investing in a wholly owned entity either by holding real estate investments through wholly owned entities of funds, such as for tax-planning purposes, or alternatively, sometimes real estate advisers could purchase real estate investments on behalf of a fund by purchasing wholly owned entities that own real estate investments instead of purchasing the real estate investments themselves directly.

\textsuperscript{158} \textit{Id.} at 938-39.


\textsuperscript{160} \textit{Id.} at 852.

\textsuperscript{161} \textit{Id.}

\textsuperscript{162} LOSS ET AL., supra note 139, § 3-A-1(d)(i)(4), at 950.

\textsuperscript{163} SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973); see also LOSS ET AL., supra note 139, § 3-A-1(d)(i)(4), at 950, n. 172 (stating that this standard “has been widely adopted in the circuits.”).
If a real estate investment adviser invests in a wholly owned partnership or limited liability company, the wholly owned partnership or limited liability company would be analyzed under the “investment contract” framework. Such interests would likely not be “securities” as there would be neither horizontal nor vertical commonality, since that form of investment would neither have a promoter nor pooling.\textsuperscript{164} Thus, real estate investment advisers could likely invest in a wholly owned partnership or limited liability company that owned real estate, without advising about “securities.”

In the event a real estate investment adviser invests in a corporation, the general issues regarding “stock” discussed above would result. Courts have generally not been forgiving with the entire sale of “stock” in a corporation in a sale of a business transaction. In \textit{Landreth Timber}, the Supreme Court rejected defendant’s contention that a sale of a business was not a “security,” even though a sale of a business was not a passive investment.\textsuperscript{165} Nonetheless, the Court in \textit{Landreth Timber} did suggest that a “stock” sale of a business could not be a “security” if the “stock” didn’t possess the traditional characteristics of “stock.” The Court noted that “the fact that instruments bear the label ‘stock’ is not of itself sufficient to invoke the coverage of the Acts. Rather, we concluded that we must also determine whether those instruments possess ‘some of the significant characteristics typically associated with’ stock . . . .”\textsuperscript{166}

Real estate advisers that find a need to invest in a wholly owned entity, if desiring to avoid “securities” issues, should invest in wholly owned non-corporate entities, such as limited liability companies or partnerships. Obviously, limited partnerships would present “securities” problems, and there is no tactical reason to prefer a wholly owned limited partnership to a wholly owned limited liability company. In the alternative, real estate investment advisers seeking to avoid “securities problems” that invest in wholly owned corporations could try to structure the stock so as to avoid bearing the major characteristics of “stock” under the Supreme Court’s analysis, thereby avoiding triggering “securities” issues. There are not a lot of cases evaluating this second type of structuring effort, so no-action relief may be desirable, given the readiness of the Court to identify “stock” as a form of “securities.” While investing in wholly owned limited liability companies or partnerships is preferable from a securities standpoint, investing in limited liability companies or partnerships may be disadvantageous from a tax standpoint, such as, without limitation, in a

\textsuperscript{164} For more detail about investment contracts and both kinds of pooling, see supra note 145.


\textsuperscript{166} \textit{Id.} at 686.
situation where a real estate adviser desires to use a corporate blocker in one of its funds.

Of course, if the wholly owned entity that would not otherwise be considered a “security” in turn invested in “securities,” then the real estate investment adviser would likely be considered an “investment adviser” by indirectly advising about securities, since Section 208(d) of the Advisers Act prohibits doing indirectly what cannot be done directly.167 Thus, there are limits to legitimate structuring attempts to avoid advising about “securities.”

E. Investments in Limited Partnerships.

Investments in limited partnership interests are generally considered to be investments in “securities.”168 Professor Loss notes that “if [the] owners participate actively in running the business,” then a limited partnership would not be a security.169 It is possible that real estate investment advisers who advise about investing in limited partnerships controlled by an investor would not be considered to be advising about securities. Though not in the Advisers Act context, appellate precedent suggests that potential control is not sufficient to take a limited partnership outside of the securities laws; rather, the investor must have actual control.170

Thus, if an investment adviser advises a fund to invest in a classic limited partnership, which in turn invests in real estate, the investment adviser will likely advise about “securities.” Only rare limited partnership investments would not implicate “securities” issues.

If investors actually actively participated in running or controlling a business structured as a limited partnership that was not a “security,” and that limited partnership invested in “securities,” then the real estate investment adviser would likely be considered an “investment adviser” by indirectly advising about securities because, as aforementioned, Section 208(d) of the Advisers Act prohibits doing indirectly what cannot be done directly.171 Thus, again, we see that there are limits to legitimate structuring attempts to avoid advising about “securities.”

168. See Loss et al., supra note 139, § 3-A-1(d)(iii), at 969-82 (stating that limited partnerships have been treated as “securities” in both the public and private context).
169. Id. at 983.
170. See Rodeo v. Gillman, 787 F.2d 1175, 1178 (7th Cir. 1986) (“Potential managerial control (at least as conditioned here) – even if easily assumed – is not enough to take a limited partnership out of the reach of the securities laws.”).
F. Investments in Other Partnerships and Joint Ventures.

In United States v. Wetherald, the Court of Appeals for the Eleventh Circuit noted:

A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers. 172

Otherwise, an investment in a partnership or a joint venture would likely not be considered a security. In Wetherald, the court concluded that the partnerships amounted to securities. 173 However, the facts forming the basis for this conclusion were egregious. Among other factors, the investors had no knowledge or experience with respect to the business; the investors did not vote on major decisions; partnership committees were symbolic; investors’ time commitment was minimal; investors did not control disbursements; investors had no say in operations; and finally, investors had no ability to obtain company information. 174

In another recent case, Nunez v. Robin, the Fifth Circuit Court of Appeals noted:

[There is a] strong presumption that a general partnership or joint venture interest is not a security. A party seeking to prove the contrary must bear a heavy burden of proof. . . . Although general partners and joint venturers may not individually have decisive control over major decisions, they do have the sort of influence which generally provides them with access to important information and protection against a dependence on others. 175

The court further stated, “[T]he securities laws do not extend to every person who lacks the specialized knowledge of his partners . . . without a

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172. United States v. Wetherald, 636 F.3d 1315, 1325–26 (11th Cir. 2011) (internal citations omitted).
173. Id. at 1327.
174. Id. at 1326.
175. Nunez v. Robin, 415 F. App’x 586, *589 (5th Cir. 2011) (per curiam) (citations and internal quotation marks omitted).
showing that this lack of knowledge prevents him from meaningfully controlling his investment.”\(^\text{176}\) The court looked to a meaningful exercise of authority in this regard, such as signing checks or contracts on behalf of the partnership or joint venture, managing finances, active management of the investment, or having access to financial information in determining whether the partner had meaningful control over his investment.\(^\text{177}\) The court also considered whether any managerial decisions were made and whether the promoter was “uniquely capable,” as well as whether the investor was a mere passive investor.\(^\text{178}\)

Loss also notes that a general partnership may be considered a “security” when it operates de facto like a limited partnership, even if it is a de jure partnership.\(^\text{179}\)

On the whole, a general partnership is a superior vehicle to investment advisers from the point of view of avoiding “securities” issues when advising about investing in real estate. However, as shown above, a partnership doesn’t always guarantee avoiding securities implications. An additional problem with general partnerships is that they give rise to pass-through taxation, and therefore cannot be used as corporate blockers.

### G. Investments in Notes

To the extent that a real estate investment 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.”\(^\text{180}\) However, the Second Circuit has stated that “not all notes are securities.”\(^\text{181}\) Nonetheless, the U.S. Supreme Court, in analyzing whether a note was a security, began with the “presumption that every note is a security.”\(^\text{182}\)

The Supreme Court in \textit{Reves v. Ernst & Young} stated that this presumption could be rebutted if the note were not a true investment, and

\(^{176}\) \textit{Id.} at *590.

\(^{177}\) \textit{See id.} at *590-91 (describing plaintiff’s active participation in the joint venture as demonstrative of his meaningful involvement in the enterprise).

\(^{178}\) \textit{See id.} at *591 (considering several factors in determining whether appellant’s ownership interest was an investment contract).

\(^{179}\) \textit{See LOSS ET AL., supra note 139, § 3-A-1(d)(ii), at 985 (“The pivotal criterion for distinguishing partnership or joint venture interests, as well as limited liability company membership interests, that are securities from those that are not usually will be the profits ‘solely [or substantially] from the efforts of others’ element in the Howey test.””) (internal footnote omitted)).

\(^{180}\) \textit{Id. § 80b-2(a)(18)}.

\(^{181}\) LOSS ET AL., supra note 139, § 3-A-1(b)(i), at 882.

discussed an attempt by the Second Circuit to divide investment notes from notes that are not securities. The following notes were not generally securities:

“[T]he 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)”.

A later case added to this list “notes evidencing loans by commercial banks for current operations.”

While the Supreme Court in Reves acknowledged that the above types of notes were not securities, the Supreme Court thought more guidance was needed as to what other types of notes may not be securities. The Supreme Court stated:

It is impossible to make any meaningful inquiry into whether an instrument bears a “resemblance” to one of the instruments identified by the Second Circuit without specifying what it is about those instruments that makes them non-“securities”. Moreover, as the Second Circuit itself has noted, its list is “not graven in stone,” and is therefore capable of expansion. Thus, some standards must be developed for determining when an item should be added to the list.

It also set forth what is known as the “family resemblance test”:

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,

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183. See id. at 65-66 (noting that the “presumption [that every note is a security] cannot be irrebuttable” and discussing the Second Circuit’s attempt to identify notes that do not fall into security category).

184. Id. at 65 (quoting Exch. Nat’l Bank v. Touche Ross & Co., 544 F.2d 1126, 1138 (2d Cir. 1976)).

185. Id. (quoting Chem. Bank v. Arthur Andersen & Co., 726 F.2d 930, 939 (2d Cir. 1984)).

186. Id.

187. Id. at 65-66 (internal citations omitted).
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.\(^{188}\)

In summarizing its view, the Court concluded:

A note is presumed to be a “security,” and that presumption may be rebutted only by a showing that the note bears a strong resemblance (in terms of the four factors we have identified) to one of the enumerated categories of instrument. If an instrument is not sufficiently similar to an item on the list, the decision whether another category should be added is to be made by examining the same factors.\(^{189}\)

In a prior no-action letter issued in the context of Section 202(a)(18) of the Advisers Act, the SEC staff implied 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 would “be a security pursuant to Section 202(a)(18) [of the Advisers Act].”\(^{190}\) Note that this no-action letter was issued prior to the \textit{Reves} decision, but the decision in \textit{Reves} may only apply in the context of the Securities Acts of 1933 and 1934.\(^{191}\) Furthermore, the SEC’s position only takes place in the context of a no-action letter, and a court could potentially decide otherwise, based on \textit{Reves}.

However, a post-\textit{Reves} federal district court case strongly suggests that a mortgage-backed note that “the lender or other commercial assignee transfers . . . to a retail broker/dealer, who then sells it to her customer,” would likely not be treated merely as a mortgage secured by a home, but

\(^{188}\) \textit{Id.} at 66–67 (internal citations omitted).

\(^{189}\) \textit{Id.} at 67.


\(^{191}\) See \textit{Reves}, 494 U.S. at 73 (“[W]e conclude that the demand notes at issue here fall under the ‘note’ category of instruments that are ‘securities’ under the 1933 and 1934 Acts.”).
would be presumed to be a security unless shown not to be under the Reves family resemblance test. The court in that case concluded that the notes “bore little resemblance to the mortgage-backed note given by a borrower to his lender in a typical home equity loan transaction,” and that therefore the mortgage-backed notes were securities.

In a more recent SEC administrative action, an issuer sold promissory notes “to individual investors to raise the funds necessary for the purchases of [mobile home] parks.” The SEC stated:

[T]his four-factor analysis reveals that the [issued] notes do not sufficiently resemble a “note secured by a mortgage on a home” to be considered a non-security under that category. The Supreme Court contemplated only mortgage-backed notes issued in the context of a traditional face-to-face transaction between a borrower and commercial or consumer lender.”

Thus, it seems safe to conclude that a mortgage-backed note purchased as an investment will likely be a security.

H. Investments in Loan Participations Interests.

“The term ‘[loan] participation’ commonly refers to an undivided fractional interest and participation in a loan, along with the interest and fees paid. This is in contrast to another popular structure where the loan is split into separate A and B loans, each with its separate promissory note.”

Real estate advisers will likely be considered to advise persons or entities about investing in “securities” if they advise them about investing in loan participation interests. Real estate advisers could potentially purchase loan participation interests in mortgages and construction loans. In a no-action letter to Putnam Diversified Premium Income Trust, the SEC staff took the position that in the context of the Investment Company Act of 1940, loan participations are “securities” because the term “security” under the Act “means ‘any note . . . evidence of indebtedness, transferable share, investment contract . . . or any certificate of interest or participation in . . . any of the foregoing.’” The definition of “security” in the Advisers Act

193. Id. at 770.
195. Id.
196. Mark S. Fawer & Michael J. Waters, Purchasing Loan Participations: The Devil is in the Details, REAL EST. FIN. J., 38 (Winter 2009).
reads in pari materia in these respects with the Investment Company Act, thus it would seem highly likely that the SEC staff would view loan participation interests as “securities” under the Advisers Act.

The SEC staff in its no-action letter to Putnam Diversified went on to explain what it meant by loan participation. In that letter, a fund would invest in:

[P]articipating interests purchased from banks in a loan made by a syndicate of banks, represented by an agent bank that has negotiated and structured the loan, to corporate borrowers to finance internal growth, mergers, acquisitions, stock repurchases, leveraged buy-outs, and other corporate activities. The loan participations may extend for the entire term of the loan or only for short “strips” that correspond to a quarterly or monthly floating rate interest period on the loan. They may take the form of (1) a true assignment or novation that shifts to the assignee the direct debtor-creditor relationship with the corporate borrower, or (2) a participating interest that does not shift the debtor-creditor relationship to the assignee, who must rely on the original lender to collect sums due and otherwise to enforce its rights against the corporate borrower or the agent bank that administers the loan.

The SEC staff identified the Fund’s apparent rationale for why the loan participation interests were “securities.” First, the SEC staff pointed to “the risk of insolvency of the corporate debtor or the issuing bank, or both, and the risk that the corporate debtor will prepay principal if interest rates fall.” Second, “[e]xcept for its investigation of the creditworthiness of the corporate borrower, the Fund will have no involvement in the commercial transactions underlying the original loans.” Third, “the Fund will purchase loan participations solely for investment purposes.” The gist of these points is that the loan participation interests were passive investments for the buyer.

In another no-action letter, the SEC staff took the position that participation in a construction period mortgage loan, e.g. a loan secured by a short-term mortgage on an unfinished construction project, was a security, analogizing it to a note. In yet another no-action letter, the SEC

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200. Id. at *2.
201. Id.
202. Id.
203. See Northwestern Ohio Bldg. & Constr. Trades Found., SEC No-Action Letter,
staff took the position in the Investment Company Act context that participating interests in notes or bonds are securities when they are purchased on the secondary market and “secured by whole home mortgages and mortgages on apartment projects, shopping centers, office buildings, and other commercial enterprises.”

I. Investments in Mortgage Backed Securities.

Mortgage-backed securities (MBS) are debt obligations that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property. Mortgage loans are purchased from banks, mortgage companies, and other originators and then assembled into pools by a governmental, quasi-governmental, or private entity. The entity then issues securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool, a process known as securitization.

Mortgage-backed securities are interests in pools of mortgages, whereas a loan participation interest could be simply a passive investment in a single loan, potentially even an unsecured loan.

Real estate advisers will likely be considered to advise persons or entities about investing in “securities” if they advise them about investing in mortgage-backed securities. Although there is limited precedent to support this proposition in the context of the Advisers Act, these types of investments would usually be analyzed under the “investment contract” or “notes” framework. In the event there is any doubt whether mortgage-backed securities are “securities” under the Advisers Act, Section 202(a)(18) of the same provides that the term “security” includes “any interest or instrument commonly known as a ‘security’ . . .”. 206

1984 SEC No-Act. LEXIS 1505, at *4 (May 21, 1984) (“The definition of the term ‘security’ in section 2(a)(36) of the Investment Company Act includes any note or participation in any note. A construction period mortgage loan, or any participation in such a loan, would, therefore, come within the definition of a security contained in section 2(a)(36).”).


J. Investments in Real Estate Sale-Leaseback Transactions

Real estate advisers will likely not be considered to advise persons or entities about investing in “securities” if they advise them about investing in real estate sale-leaseback transactions. A real estate sale-leaseback transaction is a transaction where the seller sells a real estate asset to a buyer, and then the buyer leases it back to the seller long term. In this way, the transaction functions as a loan, with payments taking the form of rent. Sale-leaseback transactions often give developers quick capital. For example, a developer could “sell [his or her] model homes and lease them back from their buyers for anywhere from a few months to a few years.” The Sixth Circuit, applying the horizontal commonality approach, has concluded that sale and leaseback arrangements are not securities, even though the purchaser purchased in the apparent belief that the model homes would appreciate in value. However, the Sixth Circuit’s view does not rule out the possibility of concluding that a sale-leaseback transaction is a “security” under the vertical commonality approach. It should be noted that the SEC recently brought administrative proceedings finding that sale-leaseback transactions were “investment contracts” in certain cases, and thus “securities.”

K. Investments in Industrial Development Bonds.

Industrial development bonds are municipal debt securities issued by a government agency on behalf of a private sector company and intended to build or acquire factories or other heavy equipment and tools. . . . Industrial Development Revenue Bonds are issued by a government to assist a private company that might otherwise be unable to obtain financing for its industrial venture or unwilling to undertake the project on its own. The government’s goal in providing the debt securities is to improve the economic and employment conditions of its region.

Real estate advisers will likely be considered to advise persons or entities about investing in “securities” if they advise them about investing in industrial development bonds. In an interpretive release, the SEC noted that industrial development bonds fall within specific categories of securities under the Advisers Act.\(^{211}\)

L. Investments in Time Share Condominiums and Analogous Real Estate Investments.

A real estate adviser will likely be considered to advise persons or entities about investing in “securities” if they advise them about investing in time-share condominiums and analogous real estate investments. Short of investments in fractional undivided interests in real estate, investments in condominiums can also present securities issues when they are “lived in during a limited part of the year but rented out during most of the year.”\(^{212}\)

Professor Paredes notes that the same “[types of securities issues apply] to offerings of all types of units in real estate developments which have characteristics similar to [condominiums that give rise to securities issues].”\(^{213}\)

Parades states:

[T]he 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.

In all of the above situations, investor protection requires the application of the federal securities laws.

If the condominiums are not offered and sold with emphasis on

\(^{211}\) See Applicability of the Investment Advisers Act to Financial Planners, Investment Advisors Act Release No. IA-1092, 1987 SEC No-Act. LEXIS 2555 (Oct. 8, 1987) (clarifying that an investment advisor’s provision of “specific investment advice” includes a recommendation, analysis or report about specific securities or specific categories of securities such as industrial development bonds, among other instruments).

\(^{212}\) LOSS ET AL., supra note 139, § 3-A-1(d)(iv), at 992.

\(^{213}\) Id.
the economic benefits to the purchaser to be derived from the managerial efforts of others, and assuming that no plan to avoid the registration requirements of the Securities Act is involved, an owner of a condominium unit may, after purchasing his unit, enter into a nonpooled rental arrangement with an agent not designated or required to be used as a condition to the purchase, whether or not such agent is affiliated with the offeror, without causing a sale of a security to be involved in the sale of the unit. Further a continuing affiliation between the developers or promoters of a project and the project by reason of maintenance arrangements does not make the unit a security.

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.

M. Investments in Undeveloped Lots.

A real estate adviser will usually not be considered to advise persons or entities about investing in “securities” if the advice is about investing in undeveloped lots, but lurking securities issues remain. “[W]hile 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.”

In McCown v. Heidler, the 10th Circuit noted 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 Acts. However, we do not agree that land or its purchase necessarily negates the application of the Securities Acts.

In McCown, the plaintiffs purchased vacant undeveloped lots. The plaintiffs argued that “[t]he vacant lots were of little value unless, by the sole efforts of [developers], the development obligations of [the developers] were fulfilled. Each of the purchasers of a . . . lot invested his

214. Id. at 992-93.
215. Id. at 995-96.
216. McCown v. Heidler, 527 F.2d 204, 208 (10th Cir. 1975).
money in a common scheme which depended solely upon the efforts of [the developers].”217 The plaintiffs argued that “[t]he lots were purchased in expectation that fulfillment of the promise to improve them by [the developer] would result in a substantial increase in the value of the lots.”218 The plaintiffs further argued that “[t]he lots were sold as, and purchased for, investment.”219 The plaintiffs presented evidence that the developers competed with Wall Street for investment money, held its real estate out to the public as an investment and referenced the enhancement of the value of the land through its managerial efforts.220 The court held that “there [was] a factual question as to whether the sale of [the] lots constitutes sales of securities.”221

As a result, real estate investment advisers need to be careful when they advise about investing in undeveloped lots. Real estate advisers should pay particular attention to whether they are relying upon the managerial efforts of others for enhancing the value of the undeveloped lots, and whether the lot is marketed to them as an investment.

N. Investments in Fractional Undivided Interests in Oil, Gas or Other Mineral Rights.

In order to understand what fractional interests in oil and gas are, one needs to understand how the typical oil and gas project is structured. Typically, speculators will acquire leases on,

[O]il and gas rights on as many of the individual tracts as they can. The tracts have typically been ‘granted, demised, leased and let’ to the lessee ‘for the sole and only purpose of mining and operating oil and gas and laying pipelines’ during a stated term of years. In these instances, the lessor has typically received, in addition to an immediate cash bonus in some cases, a promise on the part of the lessee to pay a stated rental per acre for every year in which a well is not drilled, and a further promise of a stated percentage, usually 1/8, of the oil and gas actually produced and sold or its value at the prevailing market price.222

This 1/8 interest held by the landlord is called the landowner’s royalty interest, “and it has commonly found its way into the securities markets in lots of fractional undivided portions after having been transferred to banks

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217. Id. at 209.
218. Id.
219. Id.
220. Id. at 209-10.
221. Id. at 211.
222. LOSS ET AL., supra note 139, § 3-A-1(c), at 903-04.
as collateral for loans or having been sold to an oil royalty dealer.

The 7/8 interest held by the lessee is called the working interest. The lessee may sell fractional undivided shares of the lease to raise working capital, or it may give a part interest in the lease to a drilling contractor, who in turn may sell all or part of his share to finance the drilling. As in the case of the landowners' royalty interests, which are fractions of the customary 1/8 portion, these working interests, which are fractions of the 7/8 portion, may normally have given rights of participation either in the oil or gas or in the proceeds from its sale.

A real estate adviser will likely be considered to advise persons or entities about investing in “securities” if they advise them about investing in fractional undivided interests in oil, gas or other mineral rights. Investments in fractional undivided interests in oil, gas or other mineral rights are expressly included as “securities” by Section 202(a)(18) of the Advisers Act. Prof. Paredes notes that the Federal Trade Commission posited that,

The word ‘rights’ is broad enough to make the definition applicable to interests which are regarded as giving ownership of the oil or gas in place as well as to interests which merely afford the owner the right to produce oil or gas. However, there is no fractional undivided interest if the whole landowner’s royalty interest is transferred, even though under the terms of the lease the holder may be entitled to only 1/8 or some other portion of the production.

O. Leases

A real estate adviser could under certain circumstances be considered to advise persons or entities about investing in “securities” if they advise them about investing in fractional undivided interests in leases. Professor Paredes notes that, “[a] lease arrangement normally will not involve a security. However, as illustrated by [SEC v. C.M. Joiner Leasing Corp.], the combination of a lease and other economic inducement whose value is

223. Id. at 904.
224. Id.
226. LOSS ET AL., supra note 139, § 3-A-1(c), at 905 (internal quotations and citation omitted).
substantially dependent on the efforts of a promoter or other parties can create an investment contract. In *Joiner*,

[A]n oil prospector named Joiner organized a one man corporation that acquired by assignment oil and gas leaseholds in a 3000 acre tract in Texas. The tract was given the name Joiner Paramount Development. In order to finance the drilling of a well, Joiner offered to sell to the public in widely scattered areas throughout the country instruments purporting to be assignments of leaseholds in specific portions of the tract . . . [T]he purchasers generally had no choice as to the location of the land covered by their leases. They were invited to purchase leases on undescribed, unlocated acreage that was selected in each case by the promoters. It was represented in the selling literature that a test well was being drilled, and the literature was clearly aimed at creating the impression that investors would earn a profit through the efforts of Joiner in bringing in oil, although nothing specific was said about what arrangements would be made if the well should prove successful.

In *Joiner*, the defendants first tried to argue that the assignments of leaseholds in specific portions of the tract were not “securities” because they were not typical forms of securities. The Supreme Court rejected this argument and suggested that such assignments of leaseholds were “investment contracts.” Next, the defendants attempted to argue that such assignments of leaseholds were not “securities” because they were not fractionalized interests in oil and gas, since parcels subdivided the leaseholds. The Court again rejected this argument and suggested that such assignments of leaseholds were “investment contracts.” Third, the defendants attempted to argue that such assignments of leaseholders were not “securities” because the leases and assignments under state law conveyed interests in real estate. The Court responded as follows:

In applying acts of this general purpose, the courts have not been guided by the nature of the assets back of a particular document or offering. 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 an act such as this it is not inappropriate that promoters’ offerings be judged as being what

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227. *Id.* § 3-A-1(d)(iv), at 995.
229. LOSS ET AL., supra note 139, § 3-A-1(c), at 913.
231. *Id.* at 352.
they were represented to be.\textsuperscript{232}

This latter point made by the Supreme Court suggests that any type of fractional interests in real estate leases could give rise to “securities” concerns under certain circumstances, not just fractional interests in oil and gas leases.

\textbf{P. Investments in REITs}

Over the last two or three decades, REITs emerged as an important type of real estate investment. “The term REIT refers to a ‘real estate investment trust’ as set forth in subchapter M of chapter 1 of the Internal Revenue Code of 1986.”\textsuperscript{233} REITs can include different forms of entities. “The net effect [of REIT rules] is that an entity formed as a trust, partnership, limited liability company or corporation can be a REIT.”\textsuperscript{234} REITs are essentially companies that are required to have most of their income and assets tied to real estate, and which are then permitted to achieve special federal income tax consequences.

A real estate adviser would likely be considered to advise persons or entities about investing in “securities” if they advise them about investing in REITs. From a securities standpoint, investments in most REITs would give rise to “securities” issues as the investments would be considered “stock” or “investment contracts.” For wholly owned REITs, the concerns expressed regarding wholly owned entities in general would apply.

\textbf{Q. Investments in TICs}

Today, tenancies in common (“TICs”) are a popular medium of real estate investment. The Securities Division of the State of Washington notes that “a tenancy in common is a form of property ownership in which multiple persons each own an undivided fractional interest in the entire property.”\textsuperscript{235} Typically, the investors in a TIC don’t retain managerial control.

\textquote{[A]n investment contract is involved in the public offering of fractional undivided interests in a building — whether an office

\textsuperscript{232} Id. at 352-53.


\textsuperscript{234} Id. at 3.

building or an apartment building in which equity ownership is not synonymous with occupancy — under some sort of arrangement by which the promoter or a nominee assumes the responsibility of physical management of the property and distribution of the profits to the co-owners.\textsuperscript{236}

A real estate adviser would likely be considered to advise persons or entities about investing in “securities” if they advise them about investing in tenancy in common investments (TICs). The Securities Division of the State of Washington has concluded that “[t]enancies in common may constitute ‘securities’ under the ‘investment contract’ test.”\textsuperscript{237}

At a 2007 Tenants in Common membership symposium, David Lynn, the chief counsel in the SEC Division of Corporate Finance “stated that \textit{SEC v. Mutual Benefits Corporation}, 408 F.3d 737 (11th Cir. 2005), which dealt with viatical contracts, reflected the SEC’s opinion that significant \textit{pre-purchase} managerial activities undertaken to insure the success of the investment in themselves may well make the TIC interests securities.”\textsuperscript{238} “Of course, it would be extremely difficult for a sponsor to offer TIC interests without taking pre-purchase activities to aid the success of the investment.”\textsuperscript{239} However, the Supreme Court has not definitively resolved the issue yet.

One point to note is that recently, a federal district court considered whether TICs were “securities” in \textit{San Francisco Residence Club}. The court applied the “investment contract” framework, and concluded that plaintiffs motion for summary judgment should be denied, since plaintiffs did not present “undisputed facts to establish that . . . the TIC interests were securities . . . .”\textsuperscript{240} That case hinged on the factual issue of how much managerial control was retained by plaintiffs.

This case therefore suggests that a real estate fund potentially could invest in TICs without definite securities problems if the fund retained adequate managerial control. Another possibility employed by sponsors of TICs to avoid securities issues is to hire independent management for the TIC. However, given the uncertainties in this area, seeking no-action relief under such circumstances would be advisable.

\textsuperscript{236}. \textit{Loss Et Al.}, supra note 139, § 3-A-1(d)(iv), at 991.
\textsuperscript{237}. \textit{Tenancy-in-Common Interests as ‘Securities’}, supra note 235.
\textsuperscript{239}. \textit{Id.}
R. Investments in Real Estate Derivatives

“A derivative is a contract between two or more parties whose value is based on an agreed-upon underlying financial asset, index or security. Common underlying instruments include: bonds, commodities, currencies, interest rates, market indexes and stocks.” 241

A real estate adviser could potentially be considered to advise persons or entities about investing in “securities” if they advise them about investing in real estate derivatives. Section 202(a)(18) of the Advisers Act states that the term “security” includes

any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or 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 ...

The Advisers Act suggests that a real estate derivative based on real estate that is not a security may not be a “security.” However, given that, as shown above, many real estate investments are “securities,” it is very probable in many cases that a real estate derivative would be based on a “security.” Also, real estate advisers may want to invest in foreign currency derivatives for hedging purposes, which could put it within the realm of the Advisers Act.

S. Investment in Real Estate Funds

There are many different types of real estate funds, such as public mutual funds or private equity real estate funds. A real estate adviser would likely be considered to advise persons or entities about investing in “securities” if they advise them about investing in real estate funds. Real estate funds invariably fall within the “investment contract” analysis under the Advisers Act.

T. Investment in the Fund Itself

A real estate fund investment adviser could be considered an “investment adviser” if he recommends investment in a fund that he sponsors, potentially even if the fund solely invests in non-securities real


estate. In this case, a real estate adviser can potentially mitigate the risk by limiting his advice about securities to one-off advice to invest in his fund, and explicitly stating to investors both orally and in writing that the real estate investment adviser is neither holding itself out, nor representing that he is an investment adviser. To be even safer, the real estate investment adviser should not provide recommendations to invest in the fund, and could explicitly state that he is not able to do so.

U. Conclusion

This discussion was not intended to be exhaustive of every potential scenario that could lead to a real estate investment adviser being considered an “investment adviser.” The takeaway lesson from this analysis is that if a private equity real estate investment adviser belongs to one of the fortunate categories of real estate advisers that don’t advise about “securities,” then such private equity real estate adviser will shed the title of an “investment adviser” within the meaning of the Advisers Act and will thus not be subject to the burdensome registration and compliance regime of the Advisers Act. Such advisers would likely also not be subject to the Investment Company Act and the Volcker Rule.

However, the above analysis shows that any time a private equity real estate adviser advises about real estate investments that fall within “securities,” the adviser becomes subject to the Advisers Act. The analysis above shows that a wide range of real estate investments can potentially be “securities,” including both entities and non-entity investments in real estate. Private equity real estate advisers will also need to consider that under Section 208(d) of the Advisers Act, if they restructure their operations from direct investments to indirect investments in securities, not only will they fail to reach the goal of shearing off their titles of “advisers” but their actions would be deemed illegal circumventions under the Advisers Act. For example, if any subsidiary entities were to own “securities,” the investment adviser could not avoid the Advisers Act by owning “securities” through those entities, even if those entities are not “securities.” However, Section 208(d) should generally not prohibit legitimate structuring attempts, which generally means structuring the real estate adviser’s fund’s investments so that they are not directly or indirectly

243. See LEMKE & LINS, supra note 131, § 1:7 (“[A]dvice about interests in entities that own or hold non-securities . . . would generally be considered giving advice about securities . . .”).

244. See id. § 1:5 (noting that the SEC staff looks at whether the person holds him or herself “out to the public as an investment adviser.”).

245. See 15 U.S.C. § 80b-8(a)(d) (prohibiting indirect actions that would be unlawful, under the statute, if done directly).
“securities,” without creating affiliates to invest in “securities” to evade the Advisers Act.

Unsurprisingly, sidestepping the Advisers Act is easier said than done. Oftentimes, private equity real estate investment advisers cannot walk this road, even if their goal is really just to invest in operating and developing real properties, and not in securities. Private equity real estate investment advisers should recognize that there might be considerable drawbacks to structuring their investment advice to sidestep the Advisers Act. First, structuring to avoid the Advisers Act will severely limit what types of real estate investments a private equity real estate adviser can advise on. Private equity real estate investment advisers will need to consider whether being subject to registration and regulation under the Advisers Act (and potentially state law) is worth the burden of not being able to advise about “securities.” Second, determining whether a real estate investment is a “security” may involve a lot of time, energy, and expense. Third, determining whether a real estate investment is a “security” may involve compliance uncertainty. Private equity real estate investment advisers should understand that if they decide to structure their operations so that they are not “investment advisers” on the basis that they do not generally advise about “securities,” that there could be considerable uncertainty regarding what would be considered advising about “securities.” Private equity real estate investment advisers wanting to sidestep the Advisers Act in this way should consult their counsel.

Note, private equity real estate fund investment advisers who need to advise about “securities” in a limited capacity can reduce, but perhaps not eliminate, the risk that they would be considered “investment advisers” by limiting any advice about “securities” to one-off advice and explicitly stating to investors both orally and in writing that the real estate investment adviser is neither holding himself out nor representing himself as an investment adviser.

III. THE ABILITY OF A PRIVATE EQUITY REAL ESTATE ADVISER TO SIDESTEP THE PORTIONS OF THE DODD-FRANK THAT SUBJECT PRIVATE FUNDS INVESTMENT ADVISERS TO ADDITIONAL REGULATIONS

If it is impractical for private equity real estate funds to avoid investing in securities and be exempt from the Advisers Act, is it possible for the advisers to reduce the burdens imposed by the Dodd-Frank Act in any other respects? The answer is that the Dodd-Frank Act burdens, in particular, investment advisers to “private funds.” “Private funds,” a term added to the Advisers Act by Dodd-Frank, includes an investment fund that would be an investment company as defined in Section 3 of the Investment
Company Act but for the exemptions in Sections 3(c)(1) or 3(c)(7) thereof. Prior to the Dodd-Frank Act, Sections 3(c)(1) and 3(c)(7) were the most frequently relied upon exemptions by private equity funds.

In the next portion of this article, we will consider new paths for private equity real estate investment advisers to sidestep the parts of the Dodd-Frank Act that burden investment advisers to “private funds,” most significantly Volcker Rule and Form PF.

This article predicts that private equity real estate investment advisers may likely want to restructure their funds’ exemptions to take advantage of non-(c)(1)/(c)(7) Investment Company Act exemptions, different from those that are typically relied upon. If the private equity real estate investment adviser advises Sections 3(a)(1), 3(b)(1), 3(c)(5)(C), 3(c)(6) and 3(c)(9) exempt funds under the Investment Company Act, the adviser won’t be considered advising “private funds” and thus should have the ability to avoid the Dodd-Frank Act provisions that target “private funds” advisers. It should be noted that private equity real estate investment advisers, in particular, will have the option of considering the Sections 3(a)(1), 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) and 3(c)(9) exemptions.

Before diving into the benefits of advising Section 3(a)(1), 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) and 3(c)(9) exempt funds under the Dodd-Frank Act, it is worth noting that there are also potential benefits intrinsic to the Investment Company Act itself. Section 3(c)(1) exempt funds have the advantage that the suitability requirements of Section 3(c)(1) are not as heightened as for Section 3(c)(7) exempt funds. Section 3(c)(7) exempt funds require “qualified purchasers,” a type of super accredited wealthy investor. Section 3(c)(1) exempt funds, however, have the drawback that the fund can be, “[B]eneficially owned by not more than one hundred persons.”

246. The definition of an “investment company” is beyond the scope of this article, but subject to certain exceptions, generally includes, without limitation, most types of companies that (i) invest more than 40% of their total assets (excluding government securities and cash) in securities on an unconsolidated basis, or (ii) hold themselves out as primarily engaged in the business of investing in securities. Id. § 80a-3(a)(1)(A),(C).

247. Per Section 3(c)(1), the definition of “investment company” does not include “[a]ny 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.” Investment Company Act of 1940 § 3(c)(1), 15 U.S.C. § 80a-3(c)(1) (2006).

248. Per Section 3(c)(7), the definition of “investment company” does not include “[a]ny 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.” Id. § 80a-3(c)(7)(A).

249. Id. § 80a-3(c)(1).
Since the Sections 3(a)(1), 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) and 3(c)(9) exemptions are neither limited to funds with not more than one hundred persons, nor funds with qualified purchasers, the Sections 3(a)(1), 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) and 3(c)(9) exemptions offer some attractive features under the Investment Company Act. However, the Sections 3(a)(1), 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) and 3(c)(9) exemptions have often been overlooked by practitioners due to their super-complex securities structuring problems that they pose, which potentially means (A) more compliance time, energy and expense, and (B) more compliance uncertainty. Nonetheless, it may now be the time for private equity real estate investment advisers to give them a harder look.

For private equity real estate investment advisers seeking to rely upon the new “private funds” exemption created by Dodd-Frank\(^\text{250}\) the investment adviser may need to act as an investment adviser solely to “private funds,” in which case the investment adviser may desire not to advise Section 3(a)(1), 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) and 3(c)(9) exempt investment companies, which are not “private funds.” Pursuant to Rule 203m-1, an investment adviser seeking nonetheless to utilize the Sections 3(a)(1), 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) and 3(c)(9) exemptions and the “private funds” exemption could still do so if “the investment adviser treats the issuer as a private fund under the [Advisers] Act (15 U.S.C. 80b) and the rules thereunder for all purposes.”\(^\text{251}\)

Below, this article considers how a private equity real estate investment adviser could minimize the new burdens that the Dodd-Frank imposes on advisers to “private funds,” by considering the specific benefits of advising non-(c)(1)/(c)(7) exempt funds. Private equity advisers seeking to restructure their funds in this way may wish to seek SEC staff no-action relief to confirm the legal bases for these possibilities.

A. Benefit 1 – Form PF

Beyond subjecting many investment advisers to the existing record keeping and reporting requirements framework under the Advisers Act, the Dodd-Frank Act imposes additional record keeping and reporting requirements with respect to “private funds.” Under Section 404 of the Dodd-Frank Act, the SEC may require any registered investment adviser to

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\(^{250}\) See Investment Advisers Act of 1940 § 203(m)(1), 15 U.S.C.A. § 80b-3(m)(1) (Supp. 2012) (“The Commission shall provide an exemption from the registration requirements under [the Advisers Act] to any investment adviser of private funds, if each of such investment adviser acts solely as an adviser to private funds and has assets under management in the United States of less than $150,000,000.”).

\(^{251}\) 17 C.F.R. § 275.203(m)-1(d)(5) (2013).
be subject to certain recordkeeping and reporting requirements with respect to “private funds.”

Registered investment advisers who manage one or more “private funds” are now required to file Form PF if the adviser or its related persons, collectively, have “at least $150 million in private fund assets under management as of the last of [the adviser’s] most recently completed fiscal year.” Advisers must report on Form PF certain information regarding the “private funds” they manage, and this information is intended to complement information the SEC collects on Form ADV. “Rule 204(b)-1 will require SEC-registered investment advisers who manage private funds to report risk exposure statistics on a consistent basis . . . on Form PF.”

As the definition of “private funds” under Section 402 of the Dodd-Frank Act does not include funds exempt under Sections 3(a)(1), 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) or 3(c)(9), registered private equity real estate investment that advise non-(c)(1)/(c)(7) funds should not be subject to Form PF. Not subjecting private equity real estate to Form PF was likely intended by the regulators, since private equity real estate doesn’t pose systemic risks. This is confirmed by the fact that the regulators have already finalized Form PF, and there is no indication that it applies to private equity real estate utilizing non-(c)(1)/(c)(7) exemptions.

B. Benefit 2 – 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 . . . .” In addition, the Dodd-Frank Act requires the comptroller general to conduct “a study on 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 . . . .”

254. Id.
256. See Dodd-Frank Act § 404 (explaining that private funds must disclose certain required information).
257. Id. § 416.
258. Id. § 415.
On July 11, 2011, the U.S. Government Accountability Office released a study regarding the feasibility of forming an SRO to oversee investment advisers to “private funds.”259 The study indicated that such an SRO could be done, but concluded that it would require legislation and would not be without challenges.260 Thus, it does not appear likely that such an SRO is on the horizon.

However, if there ever were further regulation of “private funds,” private equity real estate investment advisers that advise exempt funds other than “private funds,” such as Section 3(a)(1), 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) or 3(c)(9) exempt funds, would likely not be subject to such SRO oversight or increased suitability thresholds.

Not subjecting private equity real estate to a future SRO was likely intended by the regulators, since private equity real estate doesn’t pose systemic risks.

C. Benefit 3 – Foreign Private Advisers

Foreign private equity real estate investment advisers may seek to rely upon the revised Section 203(b)(3) exemption from registration under the Advisers Act for “foreign private advisers,” as defined in Section 202(a)(30) thereof.261 The Dodd-Frank Act defines the term “foreign private adviser” to mean 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.”262

Thus, if a foreign private equity real estate investment adviser advises Investment Company Act exempt funds other than “private funds,” a foreign private equity real estate investment adviser would likely be able to advise fewer than fifteen funds in the United States, and the number of investors in the United States in those would not be restricted, since the statute only restricts the number of investors in “private funds.” Thus, if a foreign private equity real estate investment were to structure its funds as Sections 3(a)(1), 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) or 3(c)(9) exempt funds, that would make it easier for them to fit within the foreign private adviser exemption under the Advisers Act.

It should be noted that an additional advantage of this type of structuring is that foreign private advisers would additionally not be subject to either the old or the new Advisers Act record keeping and reporting function.

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260. Id. at 11.
262. Dodd-Frank Act § 402(a).
provisions, including Form PF, since they wouldn’t be registered investment advisers.

The ability of private equity real estate to more easily satisfy the “foreign private advisers” exemption was likely intended by the regulators, since private equity real estate doesn’t give rise to systemic risk concerns.

D. Benefit 4 – Intrastate Advisers

The Dodd-Frank Act added that the intrastate adviser exemption in Section 203(b)(1) of the Advisers Act cannot be utilized by investment advisers that advise “private funds.” Following the Dodd-Frank Act, Section 203(b)(1) provides an exemption from registration under the Advisers Act to “any investment adviser, other than an investment adviser who acts as an investment adviser to any private fund, all of whose clients are residents of the State within which such investment adviser maintains his or its principal office and place of business.” As a result, an intrastate investment adviser seeking to avoid registration under the Advisers Act could potentially advise funds exempt under Sections 3(a)(1), 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) or 3(c)(9) of the Investment Company Act.

The ability of private equity real estate to more easily satisfy the “intrastate advisers” exemption was also likely intended by the regulators, since, as discussed above, private equity real estate doesn’t give rise to systemic risk concerns.

E. Benefit 5 – Volcker Rule

 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 exceptions, that “a banking entity shall not – (A) engage in proprietary trading; or (B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.” In addition, subject to certain carve-outs, the Volcker Rule provides that,

Any nonbank financial company supervised by the Board that engages in proprietary trading or takes or retains any equity, partnership, or other ownership interest in or sponsors a hedge fund or a private equity fund shall be subject, by rule . . . to additional capital requirements for and additional quantitative

263.  Id. § 403.
limits with regards to such proprietary trading and taking or retaining any equity, partnership, or other ownership interest in or sponsorship of a hedge fund or a private equity fund . . . . 266

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 “such similar funds” as determined by the SEC, Commodity Futures Trading Commission (CFTC) or appropriate federal banking agencies. 267

Currently, these agencies are considering promulgating rules that would broadly define “such similar funds” in such a way as to subject Sections 3(c)(1) and 3(c)(7) exempt funds, as well as other types of exempt funds and entities, to the above provisions of the Volcker Rule. If the joint agencies limit their discretion and promulgate rules that exclude from the scope of the Volcker Rule most exempt funds, other than Sections 3(c)(1) and 3(c)(7) exempt funds, then private equity real estate investment advisers would find it particularly advantageous to advise Sections 3(a)(1), 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) or 3(c)(9) exempt funds.

In 2011, the joint agencies promulgated a joint release that set forth a proposed rule, but these agencies have yet to issue a final rule. In the joint release, these agencies stated as follows: “The proposed rule follows the scope of the statutory definition by covering an issuer only if it would be an investment company, as defined in the Investment Company Act, but for section 3(c)(1) or 3(c)(7) of that Act.” 268 In footnote 222 of the joint release, the agencies noted:

Under the proposed rule, if an issuer (including an issuer of asset-backed securities) may rely on another exclusion or exemption from the definition of “investment company” under the Investment Company Act other than the exclusions contained in section 3(c)(1) or 3(c)(7) of that Act, it would not be considered a covered fund, as long as it can satisfy all of the conditions of an alternative exclusion or exemption for which it is eligible. 269

Thus, there is reason to be optimistic that the agencies will choose to limit their discretion and not apply the Volcker Rule against private equity real estate advisers utilizing non-(c)(1)/(c)(7) exemptions when they eventually promulgate a final rule. For the reasons discussed in the policy analysis

266. Id. § 1851(a)(2).
267. Id. § 1851(b)(2).
269. Id. at n.222.
section, this paper strongly urges the regulators not to apply the Volcker Rule against private equity real estate advisers utilizing non-(c)(1)/(c)(7) exemptions.

IV. A COMPLIANCE FRAMEWORK FOR PRIVATE EQUITY REAL ESTATE ADVISERS SEEKING TO UTILIZE NON-(C)(1)/(C)(7) INVESTMENT COMPANY ACT EXEMPTIONS

Following the Dodd-Frank Act, given the potential benefits of advising non-(c)(1)/(c)(7) exempt funds discussed in Part II, private equity real estate investment advisers clearly will want to consider structuring their private equity real estate funds so that they are exempt under Sections 3(a)(1), 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) or Section 3(c)(9) of the Investment Company Act. This will allow a private equity real estate investment adviser to take the position that it does not advise “private funds.” However, utilizing the Sections 3(a)(1), 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) or Section 3(c)(9) Investment Company Act exemptions involves complex securities considerations, so private equity real estate investment advisers will need to weigh the costs and benefits of this type of structuring.

Below, this part briefly summarizes these considerations. These summaries are meant only to be an introduction to the structuring considerations. The requirements of these exemptions are complex and legal counsel should be sought. For more information on Investment Company Act exemptions structuring considerations, consult Robert H. Rosenblum’s seminal treatise, Investment Company Determination under the 1940 Act: Exemptions and Exceptions.\(^\text{270}\) The reader should note in the discussion below that when the term “issuer” or “company” is used, it refers to the potential funds that a private equity real estate adviser would advise.

A. Section 3(a)(1)

The term “investment company” means, under Section 3(a)(1),

[A]ny issuer which — (1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; (2) 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 (3) is

\(^{270}\) ROSENBLUM, supra note 204.
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 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

“Investment securities,” as used in Section 3, “includes all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which (i) are not investment companies, and (ii) are not relying on the exception from the definition of investment company in paragraph (1) or (7) of subsection (c).”

“Securities” under the Investment Company Act are described by the Investment Company Act in exactly the same way as under the Advisers Act. “Security” is defined under the Investment Company Act to mean

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, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Even though the definition of “securities” is nearly the same as under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"), an instrument may be a security for Investment Company Act purposes even if it is not for purposes of the Securities Act and the Exchange Act. For example, the U.S. Supreme Court has held that bank certificates of deposit are not necessarily securities.

271. Investment Company Act of 1940 §§ 3(a)(1)-(3), 15 U.S.C. §§ 80a-3(a)(1)(A)-(C) (2006). While this article provides a brief introduction to Section 3(a)(1) issues, the reader should consult the Rosenblum treatise, supra note 204, §§ 3-5, for a more general discussion of Section 3(a)(1) issues.


273. Id. § 80a-2(a)(36).
for purposes of the Securities Act or the Exchange Act. Nonetheless, the SEC has said that bank certificates of deposit may be securities for purposes of the Investment Company Act:

While the language in the Investment Company Act’s definition of the term “security” is identical to that in the Securities Act, the regulatory context under the Investment Company Act differs fundamentally from that under the Securities Act and the Securities Exchange Act. . . . Since the bank regulatory statutes generally do not apply to the operation of [money market] funds, and since the exclusion of certificates of deposit from the definition of security in the Investment Company Act would seriously undermine the protections contemplated by Congress, the SEC believes that the relevant context requires that the term “security” take on a “different coloration” under the Investment Company Act.

In the context of real estate, the SEC staff has sometimes taken the position that an interest in real estate is not a “security” under the Investment Company Act. According to the SEC staff in Pruco, investing in “traditional non-securities real estate investments” did not require registration under the Investment Company Act, since these investments were not considered securities. However, other types of real estate interests could potentially be “securities,” which would likely entail a similar analysis as set forth in Part I of this article.

In the Investment Company Act context, the SEC staff has indicated that when a real estate fund invests in a company that invests in real estate, that investment may be a security as well. The Two-Tier Real Estate Companies release (discussed below) sets forth no-action criteria for relying upon Section 3(a)(1) when a parent partnership is a two-tier real estate company by virtue of its investments in other limited partnerships.

Certain real estate funds may thus fall outside the definition of “investment company” under Section 3(a)(1), while others potentially could fall within that definition, depending on the type of real estate investments that they make, and on whether those real estate investments

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274. See Marine Bank v. Weaver, 455 U.S. 551, 559 (1982) (“We therefore hold that the certificate of deposit . . . . is not a security.”).


276. Pruco Life Real Property Account, SEC No-Action Letter, 1986 SEC No-Act. LEXIS 2730, at *6 (Sept. 18, 1986). See also ROSENBLUM, supra note 204, § 2.3.13, at 59 (explaining that the SEC Staff does not hold an interest in real estate as a security).

277. See ROSENBLUM, supra note 204, § 2.3.13, at 59 (explaining the SEC staff’s position that interests in a company that invests in real estate are securities).

are securities investments. To the extent a real estate fund falls outside of the definition of “investment company” in Section 3(a)(1), the SEC staff has suggested that regular monitoring is required to ensure that the issuer continues to fall outside of that definition.\footnote{279} To the extent a real estate fund falls within the definition of “investment company” under Section 3(a)(1), investment advisers seeking not to advise “private funds” as a result of the Dodd-Frank Act will need to consider using Sections 3(b)(1), 3(b)(2), 3(c)(5)(C), 3(c)(6) or 3(c)(9) for an exemption from the Investment Company Act.

The drawback for real estate investment advisers of trying to fall outside the definition of “investment company” in Section 3(a)(1) is that a Section 3(a)(1) exemption would likely place severe limitations on the types of investments that a real estate fund could invest in, not to mention the ongoing monitoring requirements.

\section*{B. Sections 3(b)(1) and 3(b)(2)}

Sections 3(b)(1) and 3(b)(2) of the Investment Company Act exempt issuers from the basic definition of an “investment company” contained in Section 3(a)(1)(C) (discussed above).\footnote{280}

 Nonetheless, the Commission has taken the position that a determination under Section 3(b)(1) or 3(b)(2) that an issuer is primarily engaged in a non-investment company business also necessarily is a determination that the issuer is engaged in a noninvestment company business for purposes of Section 3(a)(1)(C) and that the issuer therefore is not an investment company under Section 3(a)(1)(A).\footnote{281}

The Rosenblum treatise adds that the Staff would not allow a company to rely upon the Sections 3(b)(1) or 3(b)(2) exemptions in the event an issuer “holds itself out as an investment company.”\footnote{282} Companies that are not exempt under either Section 3(b)(1) or 3(b)(2) always have the option of seeking Section 6(c) exemptive relief as a fall-back option.\footnote{283}

\footnote{279. See Pruco Life Real Property Account, \textit{supra} note 276, at *1 (discouraging enforcement action provided that the fund regularly monitor its accounts).}

\footnote{280. Section 3(b)(2) is a related exception to section 3(a)(1)(C), but it is not discussed, since Section 3(b)(2) is not self-operating.}

\footnote{281. ROSENBLUM, \textit{supra} note 204, § 6.2, at 157.}

\footnote{282. \textit{Id.} While this article provides a brief introduction to Sections 3(b)(1) and 3(b)(2) issues, the reader should consult Rosenblum, \textit{supra} note 204, §§ 6-7, for a more general discussion.}

\footnote{283. See \textit{id.} § 6.4, at 181 (explaining that the Commission may grant exemptive relief under Section 6(c) if the exemption is in the public interest and consistent with the protection of investors and purpose of the Investment Company Act).}
Section 3(b)(1) exempts from the definition of investment company in Section 3(a)(1)(C) “any issuer primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries,\textsuperscript{284} in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities.”\textsuperscript{285} That is, issuers that conduct an operating business through wholly-owned subsidiaries are exempted from the definition of an investment company, even though over 40 percent of their total assets technically consist of securities. The SEC takes the view that the Section 3(b)(1) and 3(b)(2) exceptions are “not available to an issuer that holds itself out as an investment company.”\textsuperscript{286}

Section 3(b)(2) of the [Investment Company] Act is closely related to Section 3(b)(1) and . . . . authorizes the Commission to declare by order that an issuer is not an investment company as defined in Section 3(a)(1)(C) if the issuer is primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities either directly, through majority-owned subsidiaries, or through controlled companies conducting similar types of businesses. . . .\textsuperscript{287}

The Commission has stated:

[C]ertain operational differences exist between section 3(b)(1) and section 3(b)(2). Section 3(b)(1) is self-operating, while section 3(b)(2) requires a Commission order. Additionally, section 3(b)(1) applies only to companies operating either directly or through wholly owned subsidiaries, while section 3(b)(2) applies additionally to companies operating through majority-owned subsidiaries and certain controlled companies. . .

\textsuperscript{284} Section 2(a)(43) of the Investment Company Act defines a wholly-owned subsidiary of a person as “a company 95 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a wholly owned subsidiary of such person.” Investment Company Act of 1940 § 2(a)(43), 15 U.S.C. § 80a-2(a)(43) (2006).

Section 2(a)(42) defines a “voting security” as “any security presently entitling the owner or holder thereof to vote for the election of directors of a company.” \textit{Id.} § 80a-2(a)(42).

[The Staff has suggested that a limited partnership (the ‘subsidiary’) may be deemed to be a wholly owned subsidiary of a parent partnership, even if the limited partnership interests are not voting securities, when the parent partnership owns at least 95 percent of the limited partnership interests of the subsidiary and the general partner of the parent partnership also will serve as the general partner of the subsidiary. \textit{Rosenblum, supra} note 204, § 6.5, at 185.


\textsuperscript{286} \textit{Rosenblum, supra} note 204, § 6.2, at 157.

\textsuperscript{287} \textit{Id.} § 6.1, at 155.
In order to rely upon either Section 3(b)(1) or Section 3(b)(2), an issuer initially must establish that it is engaged in some noninvestment business. If an identifiable noninvestment business exists, the inquiry shifts to whether that business is primary. An issuer that is primarily engaged in one or more noninvestment company businesses may be eligible to rely upon Section 3(b)(1) or Section 3(b)(2). By contrast, an issuer that is engaged, but not primarily engaged, in a noninvestment company business may not rely upon Sections 3(b)(1) and 3(b)(2).

The determination of whether an issuer is primarily engaged in a non-investment company business for purposes of Section 3(b)(1) and 3(b)(2) generally is based upon the five-factor test established in the Commission’s 1947 decision in Tonopah Mining Co. The five factors examined under the Tonopah test are (1) the issuer’s historical development, (2) its public representations of policy, (3) the activities of its officers and directors, (4) the nature of its present assets, and (5) the sources of its present income.

Occasionally, the SEC uses a different test than the Tonopah test. As related to real estate, “in certain exemptive applications involving oil, gas, and other mining companies, the Commission has from time to time looked at financial tests other than simply the percentage of assets invested in and income derived from investment securities.”

As far as non-investment company businesses are concerned, the SEC has permitted certain real estate activities to count as non-investment company businesses when the company was primarily engaged in certain real estate activities. The SEC has, at least under certain facts, permitted engaging in real estate secured lending, owning an office building, owning single family homes, engaging in the business of servicing loans.

288. Id. at 156 (internal quotation omitted).
289. Id. § 6.3, at 158 (internal quotations and footnotes omitted).
290. Id. at 158-59 (internal footnotes omitted).
291. Id. § 6.3, at 173.
294. See, e.g., Hereth, Orr and Jones, Inc., SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2951, at *14 (Sept. 2, 1983) (concluding that a company that provided a pool of investment funds to be used to purchase single family homes is not an investment company).
secured by mortgages, and investing in mortgages or being primarily engaged in the business of servicing loans secured by such mortgages. In a no-action letter, the SEC staff gave broad relief for a variety of real estate activities where the company's business primarily consisted of:

(1) originating real estate mortgage loans for sale to permanent lenders pursuant to commitments from permanent lenders to purchase such loans, (2) servicing loans for permanent lenders, (3) real estate brokerage, (4) sales of various forms of insurance, primarily to borrowers, (5) residential and commercial property management, and (6) real estate investment and development, primarily as a general partner in various limited partnerships formed for the purpose of owning multi-family and commercial real estate.

In addition, certain kinds of oil, gas, and mining businesses are also considered non-investment company businesses. However, when a real estate fund invests in real estate activities that are “securities,” then it is unlikely that the real estate fund would be considered a non-investment company business.

There are some barriers to relying upon Sections 3(b)(1) or 3(b)(2). At times, “[t]he Commission and the Staff . . . have taken the position that companies other than industrial companies and industrial holding companies are not eligible to rely upon Sections 3(b)(1) or 3(b)(2).” In addition, “the Commission and the Staff have taken the position that Sections 3(b)(1) and 3(b)(2) are not available to the types of issuers that are included among the various exemptions in Section 3(c) of the [Investment Company] Act.” However, “[i]n a number of instances . . . the Commission and the Staff have implicitly have taken the opposite position” and “the Staff has permitted issuers to rely upon Section 3(b)(1) when they have engaged . . . in certain real estate activities, even though Section

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298. See ROSENBLUM, supra note 204, § 6.4, at 176-77 (noting noninvestment businesses can include exploration, development, and distribution of oil, gas, and precious metals).

299. Id. at 179.

300. Id.
3(c)(5)(C) of the [Investment Company] Act applies to similar companies.

The SEC staff has also allowed a company to fall under the Section 3(b)(1) exemption when that company owned shares of a mineral subsidiary whose business consisted “of owning or holding oil, gas, and other mineral royalties or leases or fractional interests in oil, gas, or other mineral royalties or leases within the meaning of Section 3(c)(9)” of the Investment Company Act.

Issuers that operate non-investment real estate companies indirectly through wholly owned subsidiaries may rely upon Section 3(b)(1).

Section 3(b)(1) excepts an issuer from the definition of investment company if the issuer is primarily engaged, either directly or through a wholly owned subsidiary or subsidiaries, in a noninvestment company business. Section 3(b)(1) does not apply to issuers engaged in noninvestment company businesses through majority-owned or controlled subsidiaries, although such issuers may apply to the Commission for an exemptive order in Section 3(b)(2).

Section 2(a)(43) of the [Investment Company] Act defines a wholly owned subsidiary of a person as: a company 95 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a wholly owned subsidiary of such person.

“Thus, under Section 2(a)(43), a wholly owned subsidiary may be owned either directly by the parent company or indirectly through one or more wholly owned subsidiaries of the parent company.” It should be noted, relevant to the real estate fund context, that:

[T]he Staff has suggested that a limited partnership . . . may be deemed to be a wholly owned subsidiary of a parent partnership, even if the limited partnership interests are not voting securities, when the parent partnership owns at least 95 percent of the limited partnership interests of the subsidiary and the general partner of the parent partnership also will serve as the general partner of the subsidiary.
To the extent that the wholly owned subsidiaries themselves engage in non-operating businesses, the exception provided by Section 3(b)(1) would likely not be available, since Section 48(a) of the Investment Company Act prohibits doing indirectly what cannot be done directly.\(^\text{307}\)

The drawback for real estate investment advisers of utilizing the exemptions in Sections 3(b)(1) and 3(b)(2) is that, like utilizing the Section 3(a)(1) exemption, the Section 3(b)(1) and 3(b)(2) exemptions also would likely place severe limitations on the types of investments that a real estate fund could invest in.

C. Section 3(c)(5)(C)

1. Generally

Section 3(c)(5)(C) generally excludes from the definition of investment company, “[a]ny person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in . . . purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.”\(^\text{308}\) Below, this section discusses Section 3(c)(5)(C) in more detail.

2. Mortgage-Related Pools Concept Release

Section 3(c)(5)(C)

[W]as enacted in 1940 to exclude from regulation under the Investment Company Act companies that were engaged in the mortgage banking business and that did not resemble, or were not considered to be, issuers that were in the investment company business. Since that time, as the mortgage markets have evolved

\(^{307}\) See Investment Company Act of 1940 § 48(a), 15 U.S.C. § 80a-47(a) (2006) (“It shall be unlawful for any person, directly or indirectly, to cause to be done any act or thing through or by means of any other person which it would be unlawful for such person to do under the provisions of this subchapter or any rule, regulation, or order thereunder.”).

\(^{308}\) Id. § 80a-3(c)(5)(c). Section 3(c)(5) of the Investment Company Act also excludes from the definition of investment company, “Any person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in one or more of the following businesses: (A) Purchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services; (B) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services . . . .” Id. § 80a-3(c)(5).
and expanded, a wide variety of companies, many of them unforeseen in 1940, have relied upon Section 3(c)(5)(C). The statutory exclusion from the definition of investment company provided by Section 3(c)(5)(C) does not have an extensive legislative history and has not been comprehensively addressed by the Commission. Section 3(c)(5)(C) has been addressed in staff no-action letters on a case-by-case basis. . . .

Many different types of companies that engage in a variety of businesses rely on this exclusion. Such companies include: Those that originate and hold mortgages and participations of mortgages that they originated; companies engaged in the business of acquiring from affiliates or third parties mortgages and mortgage-related instruments (such as mortgage participations, mezzanine loans and mortgage-backed securities); companies that invest in real estate, mortgages and mortgage-related instruments; and companies whose primary business is to invest in so-called agency securities and other mortgage-backed securities.  

The Commission refers to these types of companies as mortgage-related pools, many of which are REITs.  

In September 2011, the SEC published a concept release and request for public comment focusing on, among other things, whether mortgage-related pools should be able to rely upon the Section 3(c)(5)(C) exemption.  

The Concept Release asks for views about how this exclusion should apply to mortgage-related pools, whom the Commission suggested were making judgments about their status under the Investment Company Act without sufficient Commission guidance.  

The Commission was concerned that “some types of mortgage-related pools might interpret the statutory exclusion provided by Section 3(c)(5)(C) in a broad manner, while others might interpret the exclusion too narrowly, suggesting that there may be confusion among some mortgage-related pools about when the exclusion applies.” The Commission was also “concerned that the staff no-action letters that have addressed the statutory exclusion in Section 3(c)(5)(C) may have contained, or led to,

310. Id. (internal footnotes omitted).
311. See id. at 55,302 ("Many, if not most, mortgage-related pools are corporations or business trusts that have elected to be treated as REITs for purposes of their tax status under the Internal Revenue Code.").
312. Id. at 55,300.
313. Id. at 55,301.
314. Id.
interpretations that are beyond the scope of the exclusion and inconsistent with investor protection."\textsuperscript{315} Furthermore, the Commission was “concerned that certain types of mortgage-related pools today appear to resemble in many respects investment companies such as closed-end funds and may not be the kinds of companies that were intended to be excluded from regulation under the Act by Section 3(c)(5)(C).”\textsuperscript{316}

Thus, any Section 3(c)(5)(C) discussion in this article that relates to mortgage-related pools could be subject to change in the near future.

3. Asset-Backed Issuers Concept Release

Asset-backed issuers usually hold a pool of financial assets, which subjects them to the “investment company” definition in Section 3(a)(1).

[C]ertain asset-backed issuers rely on the exclusion from the definition of investment company in Section 3(c)(5) of the Investment Company Act rather than on Rule 3a-7. Section 3(c)(5) was intended to exclude from the definition of investment company certain factoring, discounting and mortgage companies, and did not specifically contemplate asset-backed issuers, which generally did not exist at the time Congress adopted the Investment Company Act in 1940.\textsuperscript{317}

Nevertheless,

[M]any issuers of mortgage-backed securities have sought to rely on Section 3(c)(5). These asset-backed issuers include issuers of securities backed by whole residential mortgage loans and home equity loans (two of the most commonly securitized assets), whole commercial mortgages, participated mortgage interests, and “whole pool certificates” issued or guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae.\textsuperscript{318}

In August 2011, the SEC published a concept release and request for public comment “revisiting the ability of asset-backed issuers to rely on the exclusion provided by Section 3(c)(5) . . . in the aftermath of the recent financial crisis . . . .”\textsuperscript{319} Accordingly, the Commission sought comment on “whether Section 3(c)(5) should be amended to limit the ability of asset-

\textsuperscript{315} Id.
\textsuperscript{316} Id.
\textsuperscript{318} Id. at 55,320-21 (internal footnotes omitted).
\textsuperscript{319} Id. at 55,321.
backed issuers to rely on Section 3(c)(5).” Thus, any Section 3(c)(5)(C) discussion in this article that relates to asset-backed issuers could be subject to change in the near future.

4. Securities That May Not Be Issued under Section 3(c)(5)(C)

The Section 3(c)(5)(C) exclusion does not apply to issuers that are “engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates.” Concerns about issuing face-amount certificates of the installment or periodic payment plan certificates are generally not applicable to most modern real estate funds. Nonetheless, in one no-action letter, “[A] company’s proposed method of distributing . . . which contemplated annual payments for ten years and a guarantee of a maturity value at the end of the tenth year, involved the issuance of a periodic plan certificate for purposes of Section 3(c)(5).” Under Section 2(a)(32), “redeemable security” means,

[A]ny security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer’s current net assets, or the cash equivalent thereof.

The purpose of this statutory restriction was to regulate companies that invested in certain kinds of “notes, commercial paper, and mortgages and other liens on real estate [that] ‘attempted to capitalize on the popularity of open end [investment] companies by issuing redeemable securities.’” What is a redeemable security under Section 2(a)(32) can entail a highly

320. Id.
321. Investment Company Act of 1940 § 3(c)(5), 15 U.S.C. § 80a-3(c)(5) (2006). Under the Investment Company Act Section, “periodic payment plan certificate” means (A) any certificate, investment contract, or other security providing for a series of periodic payments by the holder, and representing an undivided interest in certain specified securities or in a unit or fund of securities purchased wholly or partly with the proceeds of such payments, and (B) any security the issuer of which is also issuing securities of the character described in clause (A) of this paragraph and the holder of which has substantially the same rights and privileges as those which holders of securities of the character described in clause (A) have upon completing the periodic payments for which such securities provide.” Id. § 80a-2(a)(27).
324. ROSENBLUM, supra note 204, § 15.2, at 404-05 (quoting S. REP. NO. 91-184, at 37 (1969)).
complex and fact specific analysis. Below, some of the key issues for real estate funds are traced out, but such summary is not necessarily exhaustive of every potential Section 2(a)(32) claim that can arise for real estate funds aspiring to rely upon Section 3(c)(5)(C).

[N]otwithstanding the requirement in Section 2(a)(32) that a redeemable security must entitle the holder to approximately his or her proportionate share of the issuer’s current net assets, or the cash equivalent thereof, the Staff has taken the position that a security may be a redeemable security even if a portion of the issuer’s income is excluded from the redemption rights.

In one early no-action letter, the SEC took the position that securities were redeemable securities where the fund would “offer to purchase, during a 30 day period following mailing of the year-end valuation of the limited partnership interests, any limited partnership interests tendered to it at a price equal to 90% of the their value . . . .” Clearly, a redemption option for 90% of the value of the interests is very nearly for the proportionate share of the issuer’s current net assets, or cash equivalent thereof. It is difficult to predict how the SEC staff would view, for example, a redemption option 50% of the value of the interests.

The Rosenblum treatise notes:

The Staff also takes the position that a fixed-income security entitles its holders to receive approximately their proportionate share of the issuer’s current net assets, within the meaning of Section 2(a)(32), if the holders are entitled to receive the stated dollar amount of the fixed-income security plus the accrued return on that security.

The reason for this view is that in the Citicorp no-action letter, the SEC staff stated that “[i]t is the staff’s position that the net asset value (or its equivalent) of fixed-income securities can be calculated by reference to their stated dollar amount plus accrued return.” On the other hand, the SEC staff previously indicated that “bonds were not redeemable securities when, among other things, their redemption price was based on the principal amount of the Bonds and not on the Bond holders’ proportionate shares of the issuer’s current net assets.”

325. See id. at 405-06 (providing details on what is a redeemable security within the meaning of Section 2(a)(32)).
326. Id. (internal quotations omitted).
328. ROSENBLUM, supra note 204, § 15.2, at 406.
330. ROSENBLUM, supra note 204, § 15.2, at 407, n.19 (discussing DSM Co., SEC No-
“a security is redeemable only if it is redeemable at the option of the holder. A security is not a redeemable security within the meaning of Section 2(a)(32) if it is redeemable only at the option of the issuer.”

As a general rule of thumb, this requirement is much more problematic for open-end companies than for private equity real estate funds. Most private equity real estate funds are closed-end funds, which, by definition, means that their redemption is subject to a lock-up period during which investors are not permitted to redeem. The Rosenblum treatise notes that “the Staff has taken the position that a security that may be presented to the issuer by the holder is not a redeemable security if . . . substantial restrictions are placed upon the right of redemption . . .” For real estate funds, this would clearly be the most important Section 2(a)(32) issue.

In one relatively recent no-action letter, Nebraska Higher Education Loan Program, a loan program issued three series of variable rate demand bonds to finance the purchase of student loans from originating lenders. The SEC staff took the position that the bonds subject to a three-year holding period (essentially the same thing as a lock-up) were not redeemable securities for purposes of Section 2(a)(32), but the SEC staff declined to conclude that the bonds subject to a two-week or thirty-day holding period were not redeemable securities. In between thirty-days and three years there is a considerable gray area. However, one would hope that, at a minimum, two-year lock-up periods, which tend to be at the lower end of private equity fund lock-up periods, would still not be redeemable securities for purposes of Section 2(a)(32).

Other no-action letters are promising for private equity real estate funds with various types of lock-up periods on the redeemable securities issue. In Citicorp Securities, the SEC staff wrote:

You believe that the Trust will not be issuing redeemable securities within the meaning of Section 2(a)(32) because of the limitations placed on an investor’s ability to withdraw all or a portion of its investment from the Trust prior to the targeted maturity date. Withdrawals will not be permitted during the first six months following an investment in the Trust, and thereafter, a notice period of 180 days will be required. In addition, no withdrawal will be honored if, prior to the date of honor, the Trust had received notice requiring it to honor a commitment to

Action Letter, 1986 SEC No-Act. LEXIS 2880, at *11 (Nov. 5, 1986)).
331. ROSENBLUM, supra note 204, § 15.2, at 405.
332. Id. at 406.
334. Id.
purchase Long-term Assets. We agree that, in these circumstances, the Trust will not be issuing redeemable securities.335

It should be noted that in that letter, in the alternative, “[i]nvestors will be permitted to sell their beneficial interests at any time to qualified third-party purchasers that are not affiliated with the Trust or its administrator, but only if other investors representing at least 51% of the remaining beneficial interests consent in writing to the sale.”336

In Redwood Mortgage Investors VII, the SEC staff gave no-action relief on the redeemable securities issue when a limited partnership formed as a mortgage lender gave the following withdrawal rights.337 First, limited partners could withdraw their capital after one year from the date of purchase, subject to a 10% early withdrawal penalty. The balance would be distributed in four quarterly installments. Second, limited partners could withdraw their capital commencing five years after their purchase of interests in the partnership. The capital could be withdrawn in twenty quarterly installments or longer beginning the last day of the quarter following the quarter in which the investor gives notice of the intent to withdraw. Third, after five years, limited partners could withdraw their capital from the partnership in four equal quarterly installments subject to a 10% early withdrawal penalty. The 10% penalty would be applicable to any such withdrawal prior to the time when such sums could have been withdrawn pursuant to the five-year (or longer) withdrawal period. Payments under the four payment plan also would begin on the last day of the quarter following the quarter in which the investor gave notice of his intent to withdraw from the partnership and liquidate his capital account.338

The partnership’s obligation to pay withdrawing investors would be satisfied solely from the available cash flow of the partnership. The cash flow would be available for payment to withdrawing investors after all current expenses of the partnership have been paid and adequate provisions have been made for the payment of monthly, quarterly or annual cash distributions to those investors who elect such distributions upon subscription for units. Any cash flow remaining after satisfying the above obligations would be available to pay the withdrawing investors. If the partnership’s cash flow were not sufficient to liquidate capital accounts in the above time period, the partnership would pay whatever cash flow is available to liquidate the capital accounts but would not liquidate any existing mortgage loans to pay early withdrawing investors. The

336. Id. at n.11.
338. Id. at *6-*7.
partnership would not, in any twelve month period, liquidate more than 20% of the total capital accounts outstanding at the beginning of such twelve month period. It should be noted that in granting no-action relief, the SEC staff particularly pointed to the fact that there was a one-year holding period.\footnote{339}

In \textit{California Dentists’ Guild Real Estate Mortgage Fund II}, the SEC staff gave no-action relief on the redeemable securities issue when a real estate mortgage fund made the following key representations:

\begin{enumerate}
\item the Fund will invest substantially all of its assets in mortgage loans secured by mortgages or deeds of trust on real property;
\item no investor may withdraw funds during the first 12 months following his initial investment in the Fund;
\item thereafter, an investor may withdraw funds only at the end of each calendar quarter, and only after prior notice of at least 90 days;
\item any such withdrawal by an investor will be limited to the lessor of $100,000 or 25% of the investor’s account per calendar quarter;
\item during any calendar year, the Fund will not use more than 20% of the value of its outstanding units at the beginning of such calendar year to fund withdrawals;
\item withdrawal payments will be made only to the extent that the Fund has cash available which is not invested in mortgage loans;
\item the Fund will not establish a reserve fund and in no event will any mortgage loans be sold or otherwise disposed of, or will any proceeds from the sale of new units be used, to provide cash for making withdrawal payments to investors;
\item if the total amount of withdrawals requested exceeds available cash, individual withdrawal requests will be satisfied in proportion to the total amount of withdrawals requested.\footnote{340}
\end{enumerate}

As an alternative to permitting withdrawal only to the extent that a fund had cash available that was not invested in real estate and mortgage loans, the SEC staff granted no-action relief where “funds were available from principal payments or prepayments on mortgage loans, or from the liquidation of mortgage loans for reasons other than the need to meet investor redemption requests.”\footnote{341}

\footnote{339. \textit{Id.}}
5. The “Primarily Engaged” Requirement / Types of Assets (the 55/25 Test)

As discussed above, “Paragraph (C) of Section 3(c)(5) requires an issuer to be primarily engaged in purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.” The SEC staff 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 fifty-five percent of its assets in mortgages and other liens on and interests in real estate (‘qualifying interests’).” The staff has interpreted the primarily engaged requirement also to require that “[a]n additional twenty-five percent of the issuer’s assets must be in real estate related assets [("Real Estate Related Assets")], although this percentage may be reduced to the extent that more than fifty-five percent of the issuer’s assets are invested in qualifying interests.” The remaining 20% of the issuer’s assets may be in unrestricted miscellaneous assets.

6. Temporarily Satisfying the 55/25 Test

The SEC staff has not objected if an issuer continues, [T]o rely upon Section 3(c)(5)(C) if it temporarily does not satisfy the 55/25 percent test discussed above if (1) its failure to satisfy the test results from receiving additional cash, such as from an offering of its securities or as a result of the sale of an underlying asset and (2) the issuer intends to liquidate or to use the cash to purchase additional qualifying interests as soon as possible but generally within one year.

In one no-action letter, the SEC staff stated that, Whether a longer period also would be deemed temporary would depend on such factors as (1) whether the failure of the company to become primarily engaged in a non-investment business or excepted business or liquidate within one year was due to factors beyond its control; (2) whether the company’s officers and employees during that period tried, in good faith, to effect the company’s investment of its assets in a non-investment business

342. ROSENBLUM, supra note 204, § 15.4, at 413.
343. Id. at 414 (quoting DIV. OF INV. MGMT., SEC. & EXCH. COMM’N, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 68 (1992) [hereinafter PROTECTING INVESTORS REPORT]).
344. Id.
345. Id.
346. Id. at 415. “[T]he Staff has stated that under certain circumstances a period longer than a year may be permissible.” Id.
or excepted business or to cause the liquidation of the company; and (3) whether the company invested in securities solely to preserve the value of its assets.347

7. Effect of Qualifying Interests and Real Estate Related Assets Held through Corporate Subsidiaries on the 55/25 Test

The staff has addressed situations where companies holding Qualifying Interests and Real Estate Related Assets are held through subsidiaries of an issuer. If the issuer is a two-tier partnership, then the more specific no-action guidance on two-tier partnerships discussed in the next section applies. If the issuer is a corporation holding a subsidiary corporation or partnership, or the issuer is a partnership holding a subsidiary corporation, then presumably the more generalized guidance outside of the two-tier partnerships no-action letters applies. This more generalized guidance is discussed in this section.

Generally, an issuer’s interest, for purposes of determining the 55/25 test,

[I]n any real estate that is owned by a wholly owned or majority owned subsidiary of [an issuer] or by a general partnership in which the [issuer] or a wholly owned subsidiary owns an interest will be determined by the percentage ownership interest of the [issuer] in the subsidiary or the general partnership.348

However, if,

Real estate [is] owned by a minority owned subsidiary or by a general partnership in which [the issuer] or a wholly owned subsidiary is not actively involved in the management and operation of the general partnership or in which the agreement of the [issuer] or a wholly owned subsidiary for all major decisions affecting the general partnership,349

then the real estate investment “will be considered . . . a miscellaneous investment.”350

Under Section 2(a)(24) of the Investment Company Act, a “[m]ajority-owned subsidiary’ of a person means a company 50 per cent or more of the outstanding voting securities of which are owned by

349. Id.
350. Id. at *35.
such person, or by a company which, within the meaning of this paragraph, is a majority-owned subsidiary of such person.”

8. Two-Tier Real Estate Companies

Two-tier real estate partnerships are partnerships, rather than corporations, that invest in partnerships that engage in real estate activities. “In recent years, the question of the applicability of the [Investment Company] Act to two-tier real estate companies has arisen most often in connection with limited partnerships which invest, as limited partners, in limited partnerships engaged in the real estate business.”

“In a 1974 Release . . . the Staff . . . stated that under certain conditions it would not recommend enforcement against companies that invested in partnership interests and that did not register under the [Investment Company] Act.”

The SEC staff analogized two-tier partnerships to “securities issued by majority-owned subsidiaries, which are not investment securities for purposes of Section 3(a)(1)(C).” “The Two-Tier Real Estate Companies release primarily dealt with two-tier real estate companies — that is, limited partnerships and other companies that invest in interests of other limited partnerships engaged in the real estate business.”

“[H]owever, . . . ‘the interpretive positions expressed in [the] release would apply to other types of business ventures such as cattle breeding and raising and agricultural activities.’”

The staff’s guidance said that two-tier partnerships, “will not be deemed to be an investment company under either Section 3(a)(1)(A) or Section 3(a)(1)(C) . . . when the parent partnership is a two-tier real estate company by virtue of its investments in other limited partnerships (the ‘subsidiary partnerships’) that invest in real estate” when certain conditions are met. In the Two-Tier Real Estate Companies release, the SEC staff provided the following conditions:

1. such company owns more than 50 percent of the limited partnership interests in all the limited partnerships in which it invests and has the right to dismiss and replace the general partners of such underlying companies and the limited partners of

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354. ROSENBLUM, supra note 204, § 36.1, at 783.
355. Id.
356. Id. (quoting Two-Tier Real Estate Companies, 39 Fed. Reg. at 32,130).
357. ROSENBLUM, supra note 204, § 36.2, at 784.
such company have the right to dismiss and replace their general partner or partners; (2) such company is not an investment company within the meaning of Section 3(a)(1) of the [Investment Company] Act; and (3) such company does not register under the [Investment Company] Act in reliance upon an opinion of counsel that it is not an investment company within the meaning of Section 3(a)(3) of the [Investment Company] Act.  

Rosenblum notes that “a parent partnership could be an investment company under Section 3(a)(1)(A) if, for example, it held the interests in the subsidiary partnerships as passive investments, as opposed to being actively engaged in the activities of the subsidiary partnerships . . . .”

In the Two-Tier Real Estate Companies release, the Staff also stated that a two-tier limited partnership that does not own majority interests in each of its underlying partnerships might nonetheless be eligible for an exemptive order pursuant to Section 3(b)(2) of the [Investment Company] Act if the two-tier partnership actually is engaged in the real estate business through its control of the underlying partnerships.

In order to qualify for the Section 3(b)(2) exemption,

[T]he business activities of the two-tier partnership would have to be carried out for the partnership by its general partner and, . . . an issuer would have to demonstrate that in carrying on such activities its general partner would be acting on behalf of the partnership and not on its own behalf.

The history of the two-tier partnership and its general partner, the type of compensation of the general partner, the control by the limited partners of the two-tier partnership over its general partner and over the general partners of the underlying partnerships, may be relevant, together with other factors, to the determination of whether the general partner of a two-tier company, in engaging in activities related to the business of the underlying limited partnerships, is doing so on behalf of the two-tier partnership or on its own account.

Finally, the staff has stated that a two-tier partnership that invests “in limited partnerships engaged in the development and building of housing for low and moderate income persons may qualify” for an order under

359. ROSENBLUM, supra note 204, § 36.2, at 784.
360. Id. § 36.3, at 785.
362. Id. at 32,130, n.5.
Section 6(c) exempting it from all the provisions of the Investment Company Act.\(^{363}\) However, this type of exemption requires that interests in the parent partnership are “sold only to persons for whom investment in limited profit, essentially tax-sheltered investments would not be unsuitable . . . .”\(^{364}\) In addition, “requirements for fair dealing by the general partner of the issuer with the limited partners of the issuer should be included in the basic organizational documents of the company.”\(^{365}\)

9. Joint Ventures

The SEC staff has concluded that certain joint venture investments of an issuer that invests in fee interests in real estate and mortgage loans secured exclusively by real estate, or some combination of the foregoing, would count toward the issuer’s Qualifying Assets.\(^{366}\) In *United States Property Investments*, the SEC staff gave no-action relief under Section 3(c)(5)(C) with respect to a company that would own interests in joint ventures that were formed to acquire fee interests in real estate and to make mortgage loans secured exclusively by real estate, or some combination of the foregoing.\(^{367}\) The company’s interests in joint ventures would consist exclusively of general partnership interests in joint ventures with up to three partners and in which the company’s proportionate interest would depend on its capital contribution to the joint venture. The company would have a right of first refusal to acquire the interests of the other partners. The company would be active in the management and operation of each joint venture formed to acquire interests in real estate and the agreement of the company would be required for all major decisions affecting each such joint venture. In joint ventures formed to make mortgage loans, each partner would contribute funds to be loaned and each loan would be secured exclusively by a mortgage on real estate. Although the company would acquire as little as 10% interest in the mortgage loan joint ventures, the company would have the right, by itself, to foreclose the mortgage securing the loan in the event of default.

\(^{363}\) *Id.* at 32,131.

\(^{364}\) *Id.*

\(^{365}\) *Id.*


\(^{367}\) *Id.* at *25.*
10. Satisfying the 55% Qualifying Interests Test

a. Qualifying Interests in General

As discussed above, Qualifying Interests generally include “mortgages and other liens on and interests in real estate.”\(^{368}\) There are several common types of Qualifying Interests. This article summarizes some of the major types of real estate interests that the SEC staff has suggested would constitute Qualifying Interests. Since these SEC staff positions are based on relatively old no-action letters, the views of the SEC staff may no longer be the same. Furthermore, not every single letter has been exhaustively summarized, but rather the focus has been on summarizing the most important letters. One final thing to note is that the SEC staff has generally permitted entities seeking relief under Section 3(c)(5)(C) to invest in multiple types of Qualifying Interests at the same time.\(^{369}\)

b. Fee Interests

It appears clear that, unquestionably, all forms of traditional fee interests in real estate are Qualifying Interests. In *United States Property Investments*, the SEC staff gave no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue with respect to a corporation that invested in fee interests in real estate.\(^{370}\) In one letter, it was clear that ownership interests in shopping centers were Qualifying Interests, but that point follows from the fact that fee interests in real estate are generally Qualifying Interests.\(^{371}\)

c. Leases

Investing in properties that are leased from a lessor, as well as leasing out properties owned or leased by the entity seeking to avoid the Investment Company Act, appears to receive no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue. In *Burger King Investors Master*, the SEC staff gave no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue with respect to a partnership that would acquire

\(^{368}\) ROSENBLUM, supra note 204, § 15.4, at 413.

\(^{369}\) See id., § 15.4, at 417 (citing NAB Asset Corp., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 820 (June 20, 1991) (issuer invested in real estate, whole pool mortgage-backed securities and certain real estate loans)).


leases. In that letter, the partnership would both lease properties from Burger King Corporation and, in turn, lease the properties to Burger King franchisees. In City National Bank, the SEC staff gave no-action relief under Section 3(c)(5)(C) with respect to an issuer holding individual municipal real estate leases. In Gustavus Adolphus, the SEC staff gave no-action relief under Section 3(c)(5)(C) with respect to a fund as lessor that would lease its fractional interests in land and buildings to a lessee, thereby generating income for the fund. In that letter, the lessee’s obligations to make rental payments were secured by real estate, but that representation does not appear to be necessary for no-action relief, based on an analysis of other SEC no-action letters where a company invested in real estate leases.

d. Mortgage Loans and Deeds of Trust Secured by Real Estate

In United States Property Investments, the SEC staff gave no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue with respect to a corporation that invested in mortgage loans secured by real estate. The types of letters that have received no-action relief contain a variety of factual representations, but this article attempts to explicate the key issues from these letters in terms of what types of mortgage loans secured by real estate would receive no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue.

In terms of permitted types of loans, the SEC staff has given no-action relief under Section 3(c)(5)(C) with respect to either bonds or notes secured by mortgage collateral. In one no-action letter, as a condition to no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue, the SEC staff required that bonds “be secured by a lien on real estate giving the holder the right to foreclose in the event of default.” From the perspective of obtaining no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue, it would be advisable for all mortgage collateral

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373. Id.
to give the bond holder or note holder rights to foreclose in the event of default.

In terms of subordination, in *American Housing Trust I*, the SEC staff gave no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue with respect to a trust that held loans secured by first lien mortgages and deeds of trust on real estate. In *California Dentists’ Guild*, the SEC staff gave no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue when a fund invested in mortgages on real estate, even though the fund sometimes invested in second or third mortgages or deeds of trust on real estate.

In terms of collateral, in *Breen Mortgage Fund*, the SEC staff granted no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue when the loan collateral included single-family residences, commercial property and unimproved land, but presumably all fee interest real collateral could result in no-action relief. In *Embarcadero Mortgage Fund*, the SEC staff gave no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue with respect to a limited partnership that originated mortgage loans, which were secured by deeds of trust on real property. Thus, it appears that real estate mortgages could be either originated or purchased, and still receive no-action relief under Section 3(c)(5)(C). It also appears that deeds of trust on fee interests will suffice as mortgage collateral and still receive no-action relief under Section 3(c)(5)(C).

In most no-action letters where no-action relief under Section 3(c)(5)(C) is granted on the Qualifying Interests issue, the loans have been fully collateralized, but in one no-action letter in the non-profit economic development context, each loan would generally be collateralized on at least a 75% loan-to-value ratio. In a recent no-action letter, *Capital Trust*, the SEC staff noted that “[it] generally take[s] the position that an

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asset is not a [Qualifying Interest] if it is not fully secured by [real] estate.”

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386. Dayton Area Bldg. and Constr. Indus. Found., SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2034, at *1, *27 (May 7, 1987); see also Northwestern Ohio Bldg. & Constr. Trades Found., SEC No-Action Letter, 1984 SEC No-Act. LEXIS 1505, at *4-5 (May 21, 1984) (“Because it is represented that each loan would be fully secured by real property and that the participation interests held by a trust would give the foundation, as trustee for the trust, the right by itself to foreclose the mortgage securing the loan in the event of default, it appears that a trust would be primarily engaged in purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.”).


388. Id.
Qualifying Interests issue invested in participations or fractional interests in individual or pooled mortgages or deeds of trust, provided that:

(1) such interests are created by the fractionalization of whole mortgage loans or pools of whole mortgage loans which have been purchased by [the entity]; (2) [the entity] retains a continuing percentage ownership interest of at least 10% in each whole mortgage loan or pool thereof which it has fractionalized; (3) [the entity] alone is the formal, record owner of the mortgages; and (4) [the entity] throughout the life of the participation has complete supervisory responsibility with respect to the servicing of mortgage loans included in a participation and has sole discretion as to enforcement of collections and the institution and prosecution of foreclosure or similar legal proceedings as set forth in paragraph 7 of the Participation Agreement. 389

The SEC staff stated that,

These conditions are intended to insure that if [the entity] engages primarily in acquiring undivided interests in whole mortgages or pools thereof . . . [the entity] will have a substantial continuing ownership interest in such mortgages and pools and unrestricted control over the enforcement of the lien and other matters with respect to such mortgage loans so that the interest retained by [the entity] would be an interest in real estate within the meaning of Section 3(c)(5)(C) of the Act rather than an interest in the nature of a security in another person engaged in the real estate business. 390

f. B-Notes

In Capital Trust 2009, the SEC staff granted no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue when a REIT proposed to invest in B-Notes. 391 B-Notes are a type of note that is used in A/B financings, which the SEC staff described as follows:

[I]n an A/B financing, the principal balance of a single commercial mortgage loan is divided between two or more mortgage lenders as a means of spreading the credit risk associated with the mortgage loan between the lenders. . . . [U]nlke a mortgage loan participation where each loan participant has a pari passu interest in the mortgage loan, an A/B

390. Id. at *2.
financing is a senior/subordinated structure. The senior participation, called the “A-Note,” has priority over the junior participation, called the “B-Note,” with respect to the allocation of payments made on the mortgage loan. . . . [A]ll periodic payments made by the borrower on the underlying mortgage loan are allocated first to the A-Note holder, as senior lender, in accordance with the terms of the A/B financing and then to the B-Note holder, as junior lender. . . . [I]n the event of a default on the mortgage loan, all collections or recoveries on the loan are allocated first to the A-Note holder until the A-Note holder has been fully paid before any payments are made to the B-Note holder. . . . [A]ny losses incurred with respect to the loan are allocated first to the B-Note holder and then to the A-Note holder. . . . [T]he loan is fully secured by a mortgage on the underlying commercial property and the value of the underlying commercial property at the time of the A/B financing always exceeds the combined principal balance of the B-Note and the A-Note.392

392. Id. at *1.

393. Id. at *2.

394. “[T]he B-Note is different from a second mortgage loan because the B-Note represents a participation interest in a single mortgage loan, whereas a second mortgage loan represents the issuance and administration of a separate loan. . . . [T]he separate note issued by the borrower evidences a participation in a mortgage loan and not an interest in a whole, unperticipated mortgage loan held by a single mortgagee.” Id. at *2, n.2.
invests, the B-Note holder holds a participating beneficial ownership interest in the mortgage loan and mortgage loan proceeds. The participation interest, however, is not evidenced by a separate note from the borrower and thus the [REIT] as B-Note holder is not in contractual privity with the borrower. . . . [T]he [REIT] arguably could have difficulty obtaining payment in the event that the A-Note holder files for bankruptcy. . . . [W]ith the exception of the bankruptcy issue, the two types of A/B financings are similar in all other material respects. 395

[T]he [REIT] as B-Note holder enters into an agreement with the A-Note holder that sets forth the rights and obligations of the parties (“Agreement”). . . . [U]nder the Agreement, the A-Note holder is afforded the sole and exclusive authority to administer and service the mortgage loan so long as the mortgage loan is a performing loan. The Agreement, however, provides the [REIT] as B-Note holder with approval rights with respect to any decisions relating to material modifications to the loan agreements, or in connection with any material decisions pertaining to the administration and servicing of the mortgage loan. 396

[T]he Agreement also grants the [REIT] as B-Note holder the right to control the administration and servicing of the loan in the event that the loan becomes a non-performing loan (“control rights”). . . . 397 [T]hese control rights include the right to appoint a special servicer to manage the resolution of the non-performing loan, including any proposed foreclosure or workout of the loan. . . . [T]he [REIT] generally will have the right to advise, direct, or approve certain actions to be taken by the special servicer, including those with respect to any modification or forgiveness of principal or interest in connection with the defaulted loan, any proposed foreclosure of the mortgage loan or acquisition of the underlying property by deed-in-lieu of foreclosure or any

395. Id. at *2.
396. Id. at *3.
397. “[T]he B-Note holder may exercise its control rights under the terms of the Agreement either directly or indirectly by appointing a third party (called an operating advisor) to administer its rights. . . . [G]enerally the B-Note holder retains these control rights only so long as its position in the mortgage loan is deemed to have ‘value,’ based upon an appraisal. . . . [T]he B-Note has ‘value,’ for this purpose, if the initial principal amount of the B-Note (adjusted for prepayments, debt write-downs and appraisal reduction amounts applied to the B-Note) exceeds 25% of the initial principal amount of the B-Note (adjusted for prepayments). . . . [A]n ‘appraisal reduction amount,’ for this purpose, generally is the amount by which the full outstanding mortgage indebtedness exceeds 90% of the appraised value of the underlying real property. If the appraisal indicates that the B-Note does not have ‘value,’ the B-Note holder’s control rights are forfeited to the A-Note holder.” Id. at *3, n.6.
proposed sale of a defaulted mortgage loan. . . . [T]he special servicer is generally obligated to follow the [REIT’s] decisions unless the special servicer believes that doing so would violate any applicable law or provisions of any agreement applicable to the financing arrangement. In addition, . . . the special servicer is subject to the limitations prescribed by a “servicing standard,” which requires the special servicer to act in the best interests of both the A-Note holder and the [REIT] as B-Note holder and in a commercially reasonable manner. The [REIT], however, for any reason has the right to terminate and replace the special servicer.  

[T]he [REIT] as B-Note holder has the right to receive written notice with respect to the performance of the mortgage loan and all reasonably requested information in connection with the exercise of the B-Note holder’s rights. . . . [T]he [REIT] also has the right to cure any monetary and non-monetary defaults on the mortgage loan. . . . [T]he [REIT] may purchase the A-Note at a price of par plus interest in the event that the loan becomes non-performing.

Before proceeding to evaluate whether it would grant no-action relief with respect to the B-Note assets, the SEC reiterated its position that, 

[A]n issuer that is engaged primarily in purchasing or otherwise acquiring participations or fractionalized interests in individual or pooled mortgages or deeds of trust is not entitled to rely on Section 3(c)(5)(C). [The SEC staff] has, however, taken the position that an issuer that holds mortgage participation interests may nevertheless rely on Section 3(c)(5)(C) if the mortgage participation interests have attributes that would classify them as being interests in real estate rather than as being interests in the nature of a security in another person engaged in the real estate business.

Thus, the goal of the REIT’s arguments made to the SEC staff was to convince the SEC that the B-notes were true interests in real estate rather than interests in the nature of a security in another person engaged in the real estate business.

The REIT argued,

[T]hat a B-Note is a participation interest in a mortgage loan that is fully secured by real property, and is not a loan extended to the A-Note holder. . . . [T]he B-Note is not an interest in the A-Note holder with payment depending on the profits generated by the

398. Id. at *3 (internal footnote omitted).
399. Id. at *4.
400. Id. at *5.
A-Note holder’s operations. Rather, . . . the B-Note is based on the interest and principal payments made by the borrower on the underlying mortgage loan. . . . \textsuperscript{401} [T]he [REIT] invests in a B-Note only after performing the same type of due diligence and credit underwriting procedures that it would perform if it were underwriting the entire mortgage loan. . . . \textsuperscript{402} [T]he A-Note holder does not guarantee payment of the B-Note holder’s share of interest and principal payments received from the borrower on the underlying mortgage loan. \textsuperscript{403} Accordingly, . . . the B-Note holder looks to the borrower for payment on its B-Note and not to the A-Note holder. \textsuperscript{404}

The REIT also argued that,

[T]he [REIT] as B-Note holder has rights with respect to the administration and servicing of the mortgage loan that further suggest that the B-Note is an interest in real estate. Although the A-Note holder has the exclusive authority to administer and service the mortgage loan as long as the loan is a performing loan, . . . the [REIT] as B-Note holder has approval rights in connection with any material decisions pertaining to the administration and servicing of the loan, including decisions relating to leasing and budget requests from the borrower. . . .

\textsuperscript{401} “[I]n the event that the A-Note holder becomes bankrupt and the B-Note holder is treated as an unsecured creditor of the A-Note holder, the B-Note holder may not receive its full payment on the B-Note notwithstanding the fact that the borrower has been making full and timely payments on the underlying mortgage loan. . . . [I]n the event that this will occur, the B-Note will no longer be considered [Qualifying Interests]. . . .” \textit{Id. at *6}, n. 22.

\textsuperscript{402} “[L]ike the procedures for investing in whole mortgages, the procedures that the [REIT] performs prior to investing in B-Notes include hands-on analysis of the underlying collateral for the loan, market analysis, tenant analysis, financial analysis, visits to the property, borrower background checks, and lease and contract review. . . . [T]he [REIT] performs its own independent analysis and does not rely on the A-Note holder’s analysis or conclusion on the creditworthiness of the mortgage loan borrower.” \textit{Id. at n. 23}.

\textsuperscript{403} “[T]he following additional factors indicate that the B-Note is a mortgage loan participation interest and not a loan extended to the A-Note holder: (1) there is no difference in term to maturity contained in the B-Note and the underlying mortgage loan; (2) the total payments made by the borrower on the underlying mortgage loan do not exceed the aggregate payments made on the A-Note and the B-Note; and (3) there is no difference in scheduled payment terms between the borrower and the A-Note holder, and between the A-Note holder and the [REIT], except for the priority in the allocation of interest and principal payments granted to the A-Note holder by virtue of its position as senior participant. Furthermore, . . . although there is a difference in the interest rate due on the underlying mortgage loan and the B-Note, the difference is due to the legitimate risk premium that the B-Note holder receives on assuming first loss. . . . [T]he writer’s] view that the B-Notes described in [the no-action] letter are true participations and not loans extended to the A-Note holder is based on an evaluation of the factors that the courts have considered in similar cases.” \textit{Id. at n. 24}.

\textsuperscript{404} \textit{Id. at *6}. 


The B-Note holder has approval rights with respect to any material modification to the loan agreements.\textsuperscript{405}

Finally, the REIT argued,

[A]s B-Note holder[, it] has effective control over the remedies relating to the enforcement of the mortgage loan, including ultimate control of the foreclosure process, in the event that the loan becomes non-performing. . . . [T]he [REIT] has such rights notwithstanding the fact that the [REIT] does not have the unilateral right to foreclose on the mortgage loan, or that the special servicer is required to act in the best interests of both the A-Note holder and the B-Note holder under the special servicing standard. In particular, . . . the [REIT] as B-Note holder has the right to select the special servicer, and often appoints its wholly owned subsidiary to act in that role. . . . [I]n the event that the mortgage loan becomes non-performing, the [REIT] is able to pursue the remedies it desires by advising, directing or approving the actions of the special servicer. If the [REIT] is dissatisfied with the remedy selected by the special servicer, . . . the [REIT] may: (1) terminate and replace the special servicer at any time with or without cause; (2) cure the default so that the mortgage loan is no longer non-performing; or (3) purchase the A-Note at par plus accrued interest, thereby acquiring the entire mortgage loan.\textsuperscript{406}

When the SEC staff granted no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue when a REIT proposed to invest in B-Notes, it noted that its position was based, in particular, on the following representations:

(1) a B-Note is a participation interest in a mortgage loan that is fully secured by real property; (2) the [REIT] as B-Note holder has the right to receive its proportionate share of the interest and the principal payments made on the mortgage loan by the borrower, and . . . the [REIT’s] returns on the B-Note are based on such payments; (3) the [REIT] invests in B-Notes only after performing the same type of due diligence and credit underwriting procedures that it would perform if it were underwriting the underlying mortgage loan; (4) the [REIT] as B-Note holder has approval rights in connection with any material decisions pertaining to the administration and servicing of the loan and with respect to any material modification to the loan agreements; and (5) in the event that the loan becomes non-performing, the [REIT] as B-Note holder has effective control

\textsuperscript{405} Id. at *7.
\textsuperscript{406} Id.
over the remedies relating to the enforcement of the mortgage loan, including ultimate control of the foreclosure process, by having the right to: (a) appoint the special servicer to manage the resolution of the loan; (b) advise, direct or approve the actions of the special servicer; (c) terminate the special servicer at any time with or without cause; (d) cure the default so that the mortgage loan is no longer non-performing; and (e) purchase the A-Note at par plus accrued interest, thereby acquiring the entire mortgage loan.\footnote{407}

One final thing to note about Capital Trust 2009 is that the SEC staff declined to express a view on whether an A-Note, as described in the no-action letter, is a Qualifying Interest. The SEC implied, on the A-Note issue, that it was concerned about the fact that “the B-Note holder has effective control over the remedies relating to the enforcement of the mortgage loan, including ultimate control of the foreclosure process, in the event that the loan becomes non-performing.”\footnote{408}

g. Tier 1 Mezzanine Loans

In Capital Trust, Inc., the SEC staff granted no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue when a REIT proposed to invest in Tier 1 mezzanine loans made specifically and exclusively for the financing of real estate.\footnote{409} The SEC staff described the Tier 1 mezzanine loans as follows:

[I]n a Tier 1 mezzanine loan arrangement, the [REIT] lends money as mezzanine lender to a special purpose bankruptcy remote entity (“mezzanine borrower”) whose sole purpose is to hold all of the ownership interests of another special purpose entity that owns the commercial real estate being financed and that is subject to a mortgage loan secured by the property (“property-owning entity”). . . . \footnote{410} [U]nder the terms of their respective organizational documents and loan documents, the property-owning entity may not engage in any business other than owning and holding the underlying property and the mezzanine borrower may not engage in any business other than owning and holding the ownership interests in the property-owning entity. . . . [T]he ownership interests held by the

\footnote{407. Id. (internal footnotes omitted).}{408. Id. at n.25.}{409. Capital Trust, Inc., SEC No-Action Letter, 2007 SEC No-Act. LEXIS 491, at *12-13 (May 24, 2007).}{410. “[M]ezzanine loans are junior to the senior position of the mortgage holder but senior to the equity position of the owner of the underlying real property.” Id. at *2, n.2.}
mezzanine borrower has no value apart from the underlying real property that is held by the property-owning entity other than incidental assets related to ownership of the property. The request for relief noted that there “may be multiple tiers of mezzanine loans made in connection with the financing of a property,” but the request for relief was “limited to mezzanine loans that are granted to a mezzanine borrower that directly owns interests in the entity that owns the property being financed,” hence the idea of “Tier 1” mezzanine loans, as opposed just to mezzanine loans.

The mezzanine borrower enters into an agreement with the [REIT] as Tier 1 mezzanine lender pursuant to which it pledges its entire ownership interests in the property-owning entity to the [REIT] as collateral for the mezzanine loan. The [REIT] obtains a first priority perfected security interest in the ownership interests in the property-owning entity. If the mezzanine borrower were to default on the mezzanine loan, the [REIT] has the right to foreclose on the collateral and, through its 100% ownership of the property-owning entity, become the owner of the underlying real estate.

The [REIT] as Tier 1 mezzanine lender also enters into an intercreditor agreement with the mortgage lender in connection with the issuance of the Tier 1 mezzanine loan that sets forth the relative priority of rights between the two parties with respect to claims on the underlying property being financed. Among other things, the [REIT] obtains rights under the intercreditor agreement that allow it to readily cure defaults or purchase the mortgage loan in the event of a default on the mortgage loan.

The agreement also gives the [REIT] as Tier 1 mezzanine lender various control rights over the management of the

411. *Id.* at *1-2. Incidental assets included “cash generated from rental payments and held for short periods of time pending distribution or disbursement to meet operating expenses.” *Id.* at *2, n.2.
412. *Id.* at n.1
413. “[T]he aggregate principal balance of a [mortgage] loan and mezzanine loan at origination would be less than the value of the underlying property so that the mezzanine loan would be fully secured by the underlying [real] property.” *Id.* at *3, n. 3.
414. “[T]ypically both the mezzanine borrower and the mezzanine lender are limited liability companies. . . . [I]n very rare cases the property-owning entity may be organized as a limited partnership. In such cases, the mezzanine borrower would own all of the limited partnership interests in the property-owning entity as well as all of the ownership interests in the general partner of the property-owning entity. The mezzanine borrower would pledge the ownership interests in both the property-owning entity and the general partnership as collateral for the mezzanine loan.” *Id.* at n.4
415. *Id.* at *3.
underlying property.\footnote{416} 

In the commercial real estate financing industry, second mortgages have effectively been replaced in part by Tier 1 mezzanine loans.\footnote{416} Second mortgages are rarely offered as a result of the increased practice of securitizing senior commercial mortgages.\footnote{416} The nationally recognized statistical rating organizations ("NRSROs") have expressed an unwillingness to assign the highest ratings to securities issued by a trust holding a pool of senior commercial mortgages when the underlying properties associated with these mortgages are encumbered by second mortgages.\footnote{416} The NRSROs are concerned that the presence of a second mortgage may negatively impact the trust’s remedies in the event that the senior mortgage should default, which in turn could impede payments made to the trust’s securities holders.\footnote{416} Such concerns are not found in the Tier 1 mezzanine loan arrangement because the absence of a second lien on the underlying property minimizes the likelihood that payments made to the trust’s securities holders might be affected in the event of a default of a senior mortgage in the pool.\footnote{417}

Before proceeding to evaluate whether it would grant no-action relief to the Tier 1 mezzanine loan assets, it noted that the REIT had argued “that, except for the lack of a mortgage loan against the property, such a mezzanine loan is the functional equivalent of, and provides its holder with the same economic experience as, a second mortgage.”\footnote{418} More specifically, the REIT argued as follows:

Tier 1 mezzanine loans that the [REIT] holds are the functional equivalent of second mortgages because, except for the lack of a mortgage lien on the property, all of the principal terms and features of a second mortgage loan are present.\footnote{418} Both are loans, made specifically and exclusively for the financing of real estate, that are junior to the first mortgage loan but senior to the equity position of the owner of the property.\footnote{418} Second mortgages and Tier 1 mezzanine loans are underwritten based on the same considerations and after the lender performs a hands-on analysis of the underlying commercial property, including, among other things, inspection of the property, review of revenue leases and property agreements, analyses of local commercial real estate market conditions, and review of the financial performance of the property.\footnote{418} As is typically the case with a second mortgage lender, the [REIT] exercises ongoing control
rights over the management of the underlying property, such as rights relating to the approval of major leases, budget improvements, capital expenditures and the application of insurance proceeds or condemnation awards, as well as the right to replace the property manager in case of default on the loan. Finally, . . . the [REIT] has rights under the intercreditor agreement to readily cure defaults or purchase the mortgage loan in the event of a default on the mortgage loan.419

[T]he economic experience of the [REIT] as a Tier 1 mezzanine lender is no different from the economic experience of a second mortgage lender. Although the [REIT] holds as collateral the ownership interests of the property-owning entity rather than the property itself, . . . the value of the collateral is economically the same under both loan forms. In essence, . . . the ownership interests in the property-owning entity have no economic value apart from the underlying real property (other than incidental assets related to the ownership of the property) because the property-owning entity in a Tier 1 mezzanine loan arrangement is not permitted to engage in any business except the ownership of the real property. Consequently, the [REIT] as Tier 1 mezzanine lender, like the second mortgage lender, looks to the underlying real property as the true measure of the value of its collateral. . . . [D]espite the absence of a mortgage lien, the [REIT] has the right to foreclose on the collateral and, through its ownership of the property-owning entity, become the owner of the underlying real estate.420

When the SEC staff granted no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue when a REIT proposed to invest in Tier 1 mezzanine loans, it noted that its position was based, in particular, on the following representations:

(1) a Tier 1 mezzanine loan is a subordinated loan made specifically and exclusively for the financing of real estate; (2) both second mortgages and Tier 1 mezzanine loans are underwritten based on the same considerations and after the lender performs a hands-on analysis of the property being financed; (3) the [REIT] as Tier 1 mezzanine lender exercises ongoing control rights over the management of the underlying property; (4) the [REIT] as Tier 1 mezzanine lender has the right to readily cure defaults or purchase the mortgage loan in the event of a default on the mortgage loan; (5) the true measure of the collateral securing the Tier 1 mezzanine loan is the property being financed and any incidental assets related to the ownership

419. Id. at *7-8.
420. Id. at *8-9.
of the property; and (6) the [REIT] as Tier 1 mezzanine lender has the right to foreclose on the collateral and through its ownership of the property-owning entity become the owner of the underlying property . . . .

h. Real Estate Mortgage-Backed Securities

According to the Rosenblum treatise,

[T]he Staff has taken the position that securities representing an interest in a pool of mortgages (that is, mortgage-backed securities) may be qualifying interests if the holder of those securities will have the same economic experience as a person holding the underlying mortgages (including the receipt of principal and interest payments and the risk of prepayment on the underlying mortgages).

In particular, the SEC staff has granted no-action relief in the case of certain industrial development bonds, whole pool mortgage-backed securities and agency whole pool certificates, which are each discussed below.

i. Real Estate Mortgage-Backed Securities: Industrial Development Bonds

The SEC staff has granted no-action letters when the entity seeking relief under Section 3(c)(5)(C) on the Qualifying Interests issue invested in industrial development bonds, which is not surprising since industrial development bonds are simply a form of bonds or notes secured by collateral. In Merrill Lynch, the SEC staff gave no-action relief under Section 3(c)(5)(C) with respect to a pool created by Merrill Lynch that would invest in industrial development obligations in the form of notes or bonds (“Loans”). The pool would own one or more irrevocable standby letters of credit, which Merrill Lynch arranged for banks to issue and which would guarantee the payment of the full principal and interest payments of all the loans held by the pool. The loans of the pool that were treated as Qualifying Interests (calculated on the basis of principal amount) would be secured exclusively by first mortgages or deeds of trust on real property. The loans in the pool would in all instances consist of the entire issue of

421. Id. at *12-13.
422. ROSENBLUM, supra note 204, § 15.4, at 417.
423. Id. (citing PROTECTING INVESTORS REPORT, supra note 331).
425. Id.
such loans and not portions thereof. The loans would not be of the type of security for which secondary markets exist. Once the pool was formed, it would be fixed and loans could not be added, withdrawn or substituted. Each loan would be a purchase money mortgage with the proceeds thereof being used to develop the properties that would serve as the security for such loan. There would be at least a 100% loan to value ratio (minus transactional expenses) with respect to the mortgaged property for each loan. Each loan would be assigned in its entirety to the trustee for the pool. The trustee of the pool would have the right to foreclose against the mortgage property securing the loans. Since Merrill Lynch involved mortgage pass-through certificates being sold to the investors in the pool, additional representations to obtain no-action relief were made, which are likely not necessarily relevant to real estate funds.

The SEC staff has also granted no-action letters when the entity seeking relief under Section 3(c)(5)(C) on the Qualifying Interests issue invested in loan participation interests in industrial development bonds. In Salomon Brothers, the SEC staff gave no-action relief under Section 3(c)(5)(C) with respect to a trust that would hold fractional undivided interests in real mortgages the interest on which is exempt from Federal income tax. The real estate interests would exist in the form of industrial development bonds or other obligations (“Mortgage Bonds”) secured at the time of their issuance by purchase money mortgages or deeds of trust on real estate. Each of the Mortgage Bonds would be primarily secured by purchase money mortgages or deeds of trust on real property acquired or developed with the proceeds of the Mortgage Bonds, and had a loan to value ratio at the time the Mortgage Bonds were issued of not more than 100 percent. Mortgage Bonds treated as Qualifying Interests would be secured, at the date of their issuance and at the date of issuance of the Certificates, exclusively by interests in real estate. Such Mortgage Bonds would represent the entire outstanding issue of one or more issues of Mortgage Bonds. In those cases where the mortgages or deeds of trust securing the Mortgage Bonds run to an indenture trustee for the benefit of

426. Id.
427. Id.
428. Id.
429. Id.
430. Id.
431. Id.
433. Id.
434. Id.
435. Id.
436. Id.
the holders from time to time of the Mortgage Bonds, the Trust will have the right, as the holder of the entire issue of such bonds, to direct the indenture trustee to foreclose on the real property covered by such mortgages or deeds of trust.\textsuperscript{437} In all other cases, the mortgages or deeds of trust securing the Mortgage Bonds would be assigned, and title to such mortgages transferred to the trustee, who would have the right to foreclose on the real property subject to such mortgages or deeds of trust.\textsuperscript{438} The Mortgage Bonds would not be readily tradable in any currently-existing secondary market. Since \textit{Salomon Brothers} involved mortgage pass-through certificates being sold to investors in the trust, additional representations to obtain no-action relief were made, which are likely not necessarily relevant to real estate funds.

In \textit{American Development Finance Inc.}, the SEC staff gave no-action relief under Section 3(c)(5)(C) with lighter representations with respect to a non-profit organization that would invest in local industrial development bonds.\textsuperscript{439} The non-profit was organized for the purpose of advancing the functions of economic development, job creation and community revitalization.\textsuperscript{440} A series of industrial development bonds for the borrower and the related economic development project would be purchased from a state or local economic development agency having the power to issue industrial development bonds.\textsuperscript{441} The local industrial development bonds would constitute a special, limited obligation of the local issuer payable by the local issuer solely from the revenues derived from the project.\textsuperscript{442} The revenues for payment of each bond would be derived typically from a lease, installment sale agreement or loan agreement between the local issuer and the borrower providing for an unconditional obligation on the part of the borrower to make payments at least sufficient to pay the principal of and interest on the industrial development bond as the same respectively became due.\textsuperscript{443} The lease, installment agreement or loan agreement would be assigned by the local issuer to the non-profit as holder of the industrial development bond (or to a trustee for the benefit of the non-profit), and debt service payments by the borrower would be made directly to or for the account of the non-profit (or such trustee). As security for the payment of the industrial development bond, a mortgage would be given on the project being financed.\textsuperscript{444} Each loan would be secured by a

\begin{footnotes}
\footnote{437}{\textit{Id.}}
\footnote{438}{\textit{Id.}}
\footnote{440}{\textit{Id.}}
\footnote{441}{\textit{Id.}}
\footnote{442}{\textit{Id.}}
\footnote{443}{\textit{Id.}}
\footnote{444}{\textit{Id.}}
\end{footnotes}
mortgage or deed of trust on the property which is being or to be acquired, constructed, renovated or otherwise developed through the proceeds of the loan, i.e., “purchase money mortgages”. Each loan would generally be collateralized on at least a 75% loan-to-value ratio. In many instances, the loans would be overcollateralized, but none of the loans would be materially undercollateralized.

In Citytrust, the SEC staff granted no-action relief when the entity seeking relief under Section 3(c)(5)(C) on the Qualifying Interests issue invested in both mortgage loans in the form of industrial development bonds (“Mortgage IDBs”) and equipment loans in the form of industrial development bonds (“Equipment IDBs”).

The Equipment IDBs represent loans made to fund the purchase price of equipment and costs specifically related to equipment acquisition such as installation expenses. The Mortgage IDBs represent loans made to finance the acquisition or improvement of real estate; they are secured by real estate and generally had an original loan-to-value ratio of not more than 80%. In some cases, the Mortgage IDBs are also secured by other collateral (generally equipment located on the real estate premises where the subject of the mortgage financing and, in some instances, by other assets such as a certificate of deposit and a security interest in receivables) or a guarantee (issued by the parent, another related corporation, the principals, or the individual owner/operators of the borrowing corporation).

The SEC staff appeared to suggest that both the Mortgage IDBs and Equipment IDBs were Qualifying Interests, but subject to the following criteria:

1. the original principal amount of the loan did not exceed 100% of the value of its real estate collateral when the loan was made;
2. the value of the real estate collateral was confirmed by an appraisal prepared in connection with the original loan by a qualified independent third-party appraiser retained to appraise the particular properties;
3. [the lender] applied the same underwriting criteria whether the loan was secured exclusively or additionally by other collateral or a guarantee, and
4. a Mortgage IDB benefitting from non-real estate collateral will be disqualified as [Qualifying Interests] if, in connection with a default, the amount recovered from non-real estate collateral (including guarantees) exceeds 40% of the original principal amount of the loan (the “40% test”).

446. Id. at 2.
documents] will require that recovery may not be made against non-real estate collateral on a Mortgage IDB otherwise qualifying as [Qualifying Interests] if after giving effect to such recovery (i) the 40% test will be violated with respect to such Mortgage IDB and (ii) the consequence of such violation and related disqualification would be to cause the [entity], based upon the Mortgage IDBs that continue to qualify as [Qualifying Interests] and the Equipment Loan IDBs, to fail the requirement that at least 55% of the value of the [entity’s] assets at the time of the issuance of the [interests in the entity] consisted of [Qualifying Interests] . . . .447

“Further, to qualify as [Qualifying Interests] includable in the 55%, the related IDB must represent the entire issuance of IDBs [i.e., a “whole” interest].”448 “The [entity’s] assets will be fixed at the time [the bank] conveys them to the [entity], and no substitution of [entity] assets will be permitted.”449 The entity “will have the right unilaterally to direct the IDB trustee to foreclose the mortgage securing the IDB in the event of default.”450

447. Id. at *3-4.
448. Id. at *4.
449. Id. at *4-5.
450. Id. at *6.
The SEC staff has granted no-action letters when the entity seeking relief under Section 3(c)(5)(C) on the Qualifying Interests issue invested in whole-pool mortgage-backed securities notes. In Premier Mortgage Corp., Premier Mortgage proposed “to offer to the public non-redeemable series of bonds and, with the proceeds of the offering, acquire non-recourse notes of savings and loan associations (‘S & Ls’) having a total face amount equal to the total face amount of the bonds.” 451 In reaching its position, the SEC staff noted the following critical representations:

Each note would be secured by a pool of whole mortgage loans, which are first liens on real property, owned or originated by a S&L, which would execute and deliver to [issuer] a master assignment of the mortgage loans in recordable form and a UCC-1 Financing Statement evidencing the debt created by the note. In turn, Premier would assign the notes, the payments to be made under each note, and the mortgage loans to a trustee under an indenture for the benefit of the bondholders (“the trustee”). The mortgage loans in a pool accepted by Premier as collateral would be fixed after a cut-off date (which is the day immediately preceding the effective date of the registration statement for the bonds) and no mortgage loans could be added to, withdrawn from, or substituted in the pool. On the S & L’s default, the maturity of its note would be accelerated and the trustee could sell the mortgage loans or retain them. If the trustee retains a mortgage loan, it could foreclose it upon the mortgagor’s default. Prepayments on, and adjusted proceeds of foreclosures of, mortgage loans would flow through to the trustee to be applied to the mandatory redemption of the bonds. Except to the extent that the mortgage loans are prepaid, the notes could not be prepaid without Premier’s written consent. The monthly debt service on the notes would equal the adjusted scheduled monthly payments of principal and interest on the mortgage loans. Similarly, the principal and interest rate on the notes would be the same as the principal and weighted average interest rate of the mortgage loans.

Moreover, we understand that Premier will not proceed with its proposed offering unless, among other things, the Federal Home Loan Bank Board or the Federal Savings and Loan Insurance Corporation determines that, if and when a S & L is placed in

receivership, (1) Premier, as a secured creditor, would be entitled to the full principal amount of the notes outstanding based either on the notes’ face amount or their initial offering price plus that portion of the initial issue discount amortized or (2) the receiver would arrange for the continued servicing of the mortgage loans and the continued payments on the notes.

k. Real Estate Mortgage-Backed Securities: Agency Whole Pool Certificates

The SEC staff has granted no-action letters when the entity seeking relief under Section 3(c)(5)(C) on the Qualifying Interests issue invested in agency backed whole pool certificates. In Security Mortgage Acceptance Corp., the SEC staff gave no-action relief under Section 3(c)(5)(C) with respect to a company that issued bonds backed by guaranteed mortgage pass-through certificates issued by Federal National Mortgage Association (“Fannie Mae”) and/or Mortgage Participation Certificates issued by Federal Home Loan Mortgage Corporation (“Freddie Mac”) in addition to mortgage pass-through certificates fully guaranteed as to principal and interest by Government National Mortgage Association (“Ginnie Mae”). The pass-through certificates treated as Qualifying Interests would consist of certificates representing all of the certificates backed by an underlying mortgage pool (“Whole Pool Certificates”). The letter suggested that certificates representing less than all certificates backed by an underlying mortgage pool (“Non-Whole Pool Certificates”) would not be Qualifying Interests.

In NAB Asset Corp., the SEC staff gave no-action relief under Section 3(c)(5)(C) with respect to a corporation that invested in whole pool mortgage-backed securities, noting that the SEC staff had previously granted no-action relief under Section 3(c)(5)(C) with respect to investments in Government National Mortgage Association (Ginnie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac) and/or Federal National Mortgage Association (Fannie Mae) certificates comprising an undivided interest in the entire pool of mortgages backing the certificates, which the SEC staff defined as whole pool mortgage-backed securities. Each real estate loan that was included within Qualifying Interests would meet the following criteria:

(1) the loan [would] be secured by a mortgage or deed of trust on

452. Id. at *1-3.
one or more tracts or parcels of real estate; (2) 100% of the principal amount of the loan as indicated in the credit files of the originating bank was secured by real estate at the time of origination, and (3) 100% of the fair market value of the loan [would] be secured by real estate at the time the Company receives the loan. . . .

The value of the real estate securing the loans to be acquired by the Company [would] be determined by recent independent third party appraisals. The fair market value of the real estate loans to be initially acquired by the Company [would] be determined at the book value thereof on the books of the Bank. The fair market value of the real estate loans to be acquired by the company in the future [would] be based on the acquisition prices of such loans. 455

In the Mortgages Concept Release, the SEC stated that,

The [SEC] staff has expressed the view that “whole pool certificates” that are issued or guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae (“agency whole pool certificates”) provide the holder with the same economic experience as an investor who purchases the underlying mortgages directly, [including the receipt of both principal and interest payments and the risk of prepayment on the underlying mortgage loans, notwithstanding the guarantees provided by the agencies,] and therefore would be [Q]ualifying [I]nterests. . . . 456

In the Mortgages Concept Release, the SEC requested comment on how it should treat agency whole pool certificates under Section 3(c)(5)(C), including whether it should “revisit the staff’s view that agency whole pool certificates may be treated as [Qualifying Interests].” 457

1. Loans Secured by Oil and Gas Interests

The SEC staff has extended its treatment of real estate loans to loans secured by oil and gas interests with regard to whether it will grant no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue. In Apache Petroleum Co., SEC staff gave no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue with respect to a company that invested in loans secured by oil and gas interests, such as working interests and overriding royalties. 458 The SEC further based its no-action relief on

455.  Id. at *4, 6 (internal footnote omitted).
457.  Id. at 55,307.
the fact that the combined loan interest would be comparable to market rates at the time the loan was made, and that the repayment of the principal as well as the fixed, additional, or contingent interest on the notes would be 100% secured solely by mortgages that will be exclusively on real estate, as defined under state law. In Apache Petroleum Co., the oil and gas interests were treated as real estate under state law. However, it is possible that the SEC could reach a different conclusion if oil and gas interests were not treated as real estate interests under applicable state law.

m. Installment Land Sales Contracts

An installment land contract is merely an alternative method to finance the purchase of real estate on a secured basis. In the case of an installment land contract, however, the seller would retain outright legal title to the property to be acquired, subject to its obligation to convey legal title to the buyer upon the full payment of the purchase price over the term of the contract.

Investing in installment land contracts appears to receive no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue, since installment land contracts are analogous to secured real estate loans. In American Housing Trust I, the SEC staff gave no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue with respect to a trust that invested in installment landed contracts on real estate.

n. Condominium Units and Cooperative Residential Apartments

Investing in condominiums and occupied cooperative residential apartments each appears to receive no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue. In D.B.G. Property Investors, Inc., the SEC staff gave no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue with respect to a partnership that invested in condominium units and occupied cooperative residential apartments and suggested that these investments were Qualifying Interests.

o. Condominium and Cooperative Housing Loans and Notes

Secured by Ownership Interests in Cooperative Housing or

*1-2 (Apr. 30, 1982).
459. Id.
460. Id.
in Shares of Cooperative Housing

In Greenwich Capital Acceptance, Inc., the SEC staff gave no-action relief under Section 3(c)(5)(C) on a Qualifying Interests issue with respect to a trust whose assets consisted “primarily of loans secured by ownership interests in cooperative housing. . . .” In that letter, “[e]ach Coop Loan [was] a purchase money loan secured fully and exclusively by the borrower’s interest in a cooperative apartment (‘Coop Apartment’) . . . .” The SEC staff gave no-action relief even though “the security interest held by a lender in a Coop Loan [was] not technically a mortgage . . . .” In another no-action letter, the SEC also gave no-action relief under Section 3(c)(5)(C) with respect to a corporation who planned “to engage in the business of purchasing notes (or similar obligations, i.e. bonds) . . . . secured by security interests in the shares of residential cooperative apartments . . . .”

p. Assets that are the Functional Equivalent of, and that Provide their Holder with the Same Economic Experience as, a Direct Investment in Real Estate or in a Loan or Lien Fully Secured by Real Estate.

The SEC staff has on more than one occasion noted that it has “provided no-action relief where an asset can be viewed as being the functional equivalent of, and the asset provides its holder with the same economic experience as, a direct investment in real estate or in a loan or lien fully secured by real estate . . . .” Recall that the SEC staff in Capital Trust agreed with the REIT’s argument that “except for the lack of a mortgage loan against the property, such a [Tier 1] mezzanine loan is the functional equivalent of, and provides its holder with the same economic experience as, a second mortgage.”

The SEC staff in Capital Trust discussed numerous no-action letters where the SEC staff effectively concluded that an asset could “be viewed as being the functional equivalent of, and the asset provides its holder with

464. Id. at *5.
465. Id. at *5-6.
468. Id. at *7.
the same economic experience as, a direct investment in real estate or in a loan or lien fully secured by real estate. . . .

11. Mortgages Concept Release

The SEC and staff are reviewing interpretive issues relating to the status of mortgage-related pools under the Investment Company Act, and may be in the process of changing such interpretive issues. “Mortgage-related pools” are “companies that are engaged in the business of acquiring mortgages and mortgage-related instruments and that rely on the exclusion from the definition of investment company in Section 3(c)(5)(C) of the [Investment Company] Act.” In the Mortgages Concept Release, the SEC noted that:

Some mortgage-related pools have determined that certain other assets constitute qualifying assets for purposes of that exclusion. For example, we understand that mortgage-related pools generally treat bridge loans, certain construction and rehabilitation loans, wrap-around mortgage loans and investments in distressed debt as qualifying interests, provided that the loans are fully secured by real estate. We also understand that some mortgage-related pools have determined to treat a convertible mortgage (which is a mortgage plus an option to purchase the underlying real estate) as two assets—a mortgage

469. See id. at *10 (discussing (1) Investors GNMA Trust, Inc., SEC Staff No-Action Letter, 1983 WL 28500 (July 22, 1983), “where counsel opined that the issuer’s ownership of GNMA Mortgage Pass-Through Securities representing 100% beneficial interests in mortgage pools constitutes an investment in mortgages within the meaning of Section 3(c)(5)(C) because ownership of these securities ‘is the functional equivalent of ownership of the underlying mortgage loans,’” (2) GEM Savings Association, SEC Staff No-Action Letter, 1983 WL 28748 (Sept. 28, 1983), where “counsel argued that issuer’s ownership of GNMA certificates is the ‘functional equivalent of ownership in an interest in real estate,’ thereby permitting the issuer to rely on Section 3(c)(5)(C), because the certificates represent 100% beneficial interests in each underlying mortgage pool, the payment of principal and interest on the underlying mortgages is passed through to holders of GNMA certificates and the certificates are secured by the real estate associated with the underlying mortgages,” (3) NAB Asset Corp., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 820 (June 20, 1991), where “counsel stated that an issuer that has general partnership interests in partnerships that hold real estate and loans backed by real estate should be ‘functional equivalents of direct ownership in the real estate and loans held by the partnerships and not be ‘securities’ for securities law purposes,’” (4) U.S. Prop. Invs., N.V., SEC No-Action Letter, 1989 SEC No-Act. LEXIS 641 (May 1, 1989), where “counsel argued that issuer’s joint venture investments in real estate and mortgages are the ‘functional equivalents of direct ownership by the . . . [issuer], and would not constitute ‘securities’ under the ‘investment contract test’ used for securities law purposes.”)

loan (treated as a qualifying interest provided that it is fully secured by real estate) and an option to purchase real estate (which is assigned an independent value and treated as a real estate-type interest).

With respect to certain other mortgage-related instruments, there appears to be a degree of uncertainty or differing views among mortgage-related pools as to the availability of the Section 3(c)(5)(C) exclusion. For example, it appears that some mortgage-related pools that invest in certificates issued by pools that hold whole loans and participation interests in loans that are secured by commercial real estate (“CMBS”) limit the amount of CMBS that they hold, treating such assets as real estate-type interests under Section 3(c)(5)(C), whereas others treat certain CMBS as qualifying interests.471

In the Mortgages Concept Release, the SEC noted that,

The evolution of mortgage-related pools and the development of new and complex mortgage-related instruments, the Commission is reviewing interpretive issues relating to the status of mortgage-related pools under the Investment Company Act and whether mortgage-related pools potentially are making judgments about their status under the [Investment Company] Act without sufficient Commission guidance. It appears that some types of mortgage-related pools might interpret the statutory exclusion provided by Section 3(c)(5)(C) in a broad manner, while others might interpret the exclusion too narrowly. . . . The Commission also is concerned that staff no-action letters that have addressed the statutory exclusion in Section 3(c)(5)(C) may have contained, or led to, interpretations that are beyond the intended scope of the exclusion and inconsistent with investor protection.472

In particular, in the Mortgages Concept Release, the SEC sought comment on the following issues:

- Whether “Section 3(c)(5)(C) is generally being used consistent with the purposes and policies underlying that provision and investor protection?”473

- Whether “certain mortgage-related pools may be giving too broad an interpretation to [Section 3(c)(5)(C)]? If so, does such broad interpretation result in companies that resemble traditional investment companies avoiding regulation under the Act, and, if

471. Id. at 55,306.
472. Id. at 55,301.
473. Id. at 55,306.
so, is it inconsistent with the purposes and policies underlying that provision and investor protection?  

- Whether “certain companies may be giving to narrow an interpretation to [Section 3(c)(5)(C)]?”

- Whether the 55%/45% is “an appropriate approach to determining an issuer’s primary engagement for purposes of Section 3(c)(5)(C)?”

- “[W]hether any of the staff’s analysis relating to the determination of whether an asset is a ‘lien on or interest in real estate’ for purposes of Section 3(c)(5)(C) would be relevant in formulating Commission guidance for today’s mortgage-related pools.”

- “[S]hould certain mortgage participations be treated as interests in real estate and, if so, what types of participations and why?”

- “Is a company whose primary business activity consists of holding mortgage participations, the type of entity that should be excluded from the definition of investment company? Why or why not, and does it matter what type(s) of participations the company holds?”

- “If participations are to be treated as interests in real estate, what features should be considered in making a determination about such assets?”

- “Should the Commission revisit the staff’s view that agency whole pool certificates may be treated as interests in real estate?”

- “[W]hether guidance is needed with respect to other mortgage-related instruments. If so, which instruments and what should that guidance provide? We note in particular the differing approaches taken by certain mortgage-related pools as to the appropriate

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474. Id.
475. Id.
476. Id.
477. Id. at 55,307
478. Id.
479. Id.
480. Id.
481. Id.
treatment of certain types of CMBS for purposes of determining a company’s ability to rely on Section 3(c)(5)(C).”

- “[W]hether a company whose primary business consists of investing in CMBS, or any other type of mortgage-backed security, is the type of entity that Congress intended to be encompassed by the exclusion provided by Section 3(c)(5)(C).”

12. Interests that are Not Qualifying Interests

“The Staff has taken the position that assets that do not represent interests in or loans backed by real estate are not Qualifying Interests.”

a. Mortgage Placement Fees

A mortgage placement fee is generally a fee charged by a mortgage broker for negotiating a loan between the lender and the borrower. In G.A.B.E., the SEC staff declined to give no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue to a company that was in the business of acquiring mortgages on real estate because too much of the company’s gross revenues may have been attributable to mortgage placement fees rather than interest income from mortgages and other liens acquired with funds from investors. Moreover, the holders of some of the company’s securities had interests that lied exclusively in mortgage placement fees.

Presumably, the SEC staff’s view is that the interest from a mortgage is part of the investment in the mortgage, but the revenues earned from placement fees are not Qualifying Interests. Similarly, the SEC staff’s decision suggests that a company in “the business of making mortgage placements” does not fall within Qualifying Interests.

b. Notes Not Secured Exclusively by a Mortgage or Deed of

482. In the Mortgages Concept Release, the SEC noted how “some mortgage-related pools that invest in certificates issued by pools that hold whole-loans and participation interests in loans that are secured by commercial real estate . . . .” Id. at 55,306. Such certificates are what the SEC meant by CMBS.

483. Id.

484. Id.

485. ROSENBLUM, supra note 204, § 15.4.2(ii), at 419.

Trust on Real Property

In Newman and Associates, the SEC declined to give no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue to a trust that invested in notes of the owner of a real estate project “where none of the [notes] is secured exclusively by a mortgage or deed of trust on real property.”487 The owner of the real estate project was the Borrower under the notes. In that no-action letter, “[t]he Borrower [would] purchase a surety bond, which [would] insure the availability to the [trust] of sufficient moneys to pay the principal of and interest on the [bonds sold to trust investors] when due in the event the Borrower defaults on the [notes].”488 “The Borrower’s obligations to indemnify and hold the surety harmless from all loss, cost, liability, or expense in connection with the [project] and its financing [would] be secured by a first mortgage lien on the [project] and certain other rights and properties which [would] be mortgaged, assigned, or pledged to the surety (collectively, ‘Collateral Security’).”489 “The Trustee [would] be subrogated to the rights of the surety with respect to the Collateral Security if (a) the surety is placed in receivership or (b) the Borrower and the surety both default in making payments sufficient to pay the principal of and interest on the Bonds.”490 None of these attempts, however, remedied the fact that the notes did not fall within Qualifying Interests since they were not secured exclusively by a mortgage or deed of trust on real property.

c. Notes Not Fully Secured by Real Estate

In Prescott, Ball & Turben, the SEC staff declined to give no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue to a company that would invest in notes that were not “fully secured solely by real estate,” even though the notes were “primarily secured by real estate.”491 Under certain limited circumstances, however, the SEC staff appears to have granted no-action relief when notes were not fully secured by real estate.

488. Id.
489. Id.
490. Id.
d. Participations or Fractionalized Interests in Individual or Pooled Mortgages or Deeds of Trust

As discussed above, in Capital Trust 2009, the SEC staff clarified that,

[A]n issuer that is engaged primarily in purchasing or otherwise acquiring participations or fractionalized interests in individual or pooled mortgages or deeds of trust is not entitled to rely on Section 3(c)(5)(C). We have, however, taken the position that an issuer that holds mortgage participation interests may nevertheless rely on Section 3(c)(5)(C) if the mortgage participation interests have attributes that would classify them as being interests in real estate rather than as being interests in the nature of a security in another person engaged in the real estate business. 492

In one no-action letter, the SEC staff denied no-action relief on the Section 3(c)(5)(C) issue because the pool consisted of fractionalized interests in notes representing less than all of the outstanding notes of that issue and the pool would not be in a position to foreclose the mortgages securing the notes. 493 Instances in which participations or fractionalized interests in individual or pooled mortgages or deeds of trust fall within Qualifying Interests are discussed above.

e. Entities that Invest in Real Estate and Related Assets or that are Engaged in the Real Estate Business

Investments in entities that invest in real estate and related assets or that are engaged in the real estate business themselves do not count as Qualifying Interests for the funds investing in those entities, even if the entities in which the fund invests qualify under Section 3(c)(5)(C). In M.D.C. Holdings, the SEC staff declined to give no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue to a REIT that invested “in various partnerships and trusts (‘Entities’) which invest in real estate-related assets . . . “494 In The Realex Capital Corp., the SEC staff declined to give no-action relief under Section 3(c)(5)(C) on the Qualifying Interests

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issue to an issuer that “would be formed to invest in limited partnership interests in an underlying limited partnership that would own and operate a building.”

Despite these concerns, however, the SEC staff has occasionally, as discussed above, granted no-action relief on the Section 3(c)(5)(C) issue with respect to corporate subsidiaries, two-tier investment companies, and joint ventures.

f. Certain Whole or Partial Pool Certificates

In the Mortgages Concept Release, the SEC wrote that agency partial pool certificates that represent “less than the entire ownership interest in a mortgage pool” have not been considered Qualifying Interests because they are “more akin to being an investment in the securities of an issuer holding mortgages rather than an investment directly in the underlying mortgages . . .” The rationale is that an investor in partial pool certificates obtains greater diversification and is subject to a different prepayment risk than an investor who purchases the underlying mortgages directly.

However, entities may treat these types of assets as Real Estate Related Assets for purposes of determining whether an issuer may rely on Section 3(c)(5)(C). Nonetheless, the SEC staff has concluded that whole or partial pool certificates issued by private issuers are generally not Qualifying Interests. It is unclear whether this SEC statement overrules the Premier Mortgage no-action letter.

497. PROTECTING INVESTORS REPORT, supra note 343, at 73.
498. See id. (reporting that the fundamental protections of the Investment Company Act of 1940 should remain intact with only minor adjustments for recent changes in financial markets).
499. Id.
500. See Premier Mortg. Corp., SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2145, at *1-3 (Mar. 14, 1983) (recommending the SEC take no action against mortgage corporation attempting to buy fully secured loan notes with proceeds from public bond offering since corporation’s investment in the notes would result in a substantially similar investment experience as a direct investment in the underlying mortgages themselves).
g. Private Residential Mortgage Loans Held by the Issuer under Funding Agreements

“[T]he Staff has stated that private residential mortgage loans (as opposed to loans issued by financial institutions) held by the issuer under funding agreements are not qualifying interests.”501

h. Rights to Receive the Cash Flows On, and Beneficial Interests In, Certain Mortgages When Another Legal Entity Retained Legal Title to the Mortgages

The Rosenblum treatise notes that the SEC staff “appears to take the position to rely upon Section 3(c)(5)(C), an issuer must have full ownership of the [Q]ualifying [I]nterests.”502

In HUD Multifamily, the SEC staff declined to give no-action relief under Section 3(c)(5)(C) on the Qualifying Interests issue to a trust whose assets would “consist of the cash flows on, and beneficial interests in, certain multifamily project mortgage loans.”503 In that letter, “(1) HUD [would retain] ‘bare legal title’ to the mortgages . . . ; (2) HUD [would control] the right to foreclose on the mortgages . . . ; and (3) HUD’s obligations . . . may result in action or inaction that may not be consistent with the economic interests of the [investors] . . . .”504 The SEC staff thus concluded that an issuer must hold legal title, control the right to foreclose, and be able to act in a manner that is consistent with the goals of interest holders in the issuer in order to establish a Qualifying Interest.505

In another release, the SEC noted the following:

Defendants argued that they satisfied [Section 3(c)(5)(C)] by acquiring, for a nominal sum, a residual interest in two trusts that had issued mortgaged backed bonds to the public. By structuring the transactions in a particular way, defendants were able to put on their own books all of the mortgages in the trusts . . . even though defendants did not own the mortgages. The Court rejected this argument, held that defendants were unregistered investment companies and appointed a trustee to take over the management of the defendants’ business.506

501. ROSENBLUM, supra note 204, § 15.4.2(ii), at 421.
502. Id.
504. Id. at 1-2.
505. Id. at *1-2.
13. Section 6(c) Exemptive Orders

Congress has encouraged the proliferation of mortgage-backed securities:

In 1984, Congress enacted the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA), in order to broaden “the market for mortgage-backed securities by encouraging more extensive involvement of the private sector in the formation of conduits for the flow of mortgage capital from investors to lenders and homebuyers.” In enacting SMMEA, Congress recognized that the vast majority of the mortgage-backed securities were (and are) issued or guaranteed by Ginnie Mae, Fannie Mae, and Freddie Mac and sought to reduce regulatory barriers preventing private companies from also issuing mortgage-backed securities.507

In addition, Congress expected the SEC to facilitate mortgage-backed securities:

In enacting SMMEA . . . Congress also stated that it expected the Commission to “monitor the private secondary mortgage market and provide appropriate administrative relief from the provisions of the [1940] Act if compliance with the Act unnecessarily [hinders] development of the market.” In particular, Congress noted the Commission authority under Section 6(c) of the 1940 Act to grant exemption from any provisions of that Act and stated that it expected “the Commission will exercise this authority with a view to encouraging a vigorous private secondary mortgage market.”

Following the enactment of SMMEA, the SEC has exempted many mortgage-backed securities under Section 6(c), with a view to encouraging private secondary mortgage market transactions.509 “Most of the exemptive orders concern CMOs510 and REMICs511 whose assets consist primarily of

507. ROSENBLUM, supra note 204, § 15.7, at 426 (internal footnotes omitted).
508. Id. at 427 (internal footnotes omitted).
509. Id. (citing S. REP. NO. 98-293 9 (1984)).
510. “A CMO is a debt obligation whose structure allows the cash flows on the underlying mortgage pools to be carved up into separate classes of securities, called ‘tranches,’ each with a specified coupon and stated maturity. Scheduled payments and prepayments from the mortgage pool are allocated to retire the classes in the order of stated maturities.” PROTECTING INVESTORS REPORT, supra note 343, at 8–9.
511. Many issuers elect to be treated as real estate mortgage investment conduits (“REMICs”), which were created by the Tax Reform Act of 1986. REMIC status affects only the taxation of the issuer and the investors — the securities law and accounting requirements remain the same. Only issuers of securitized mortgage products can elect REMIC status.
partial pool certificates and other mortgage-related assets that are not qualifying interests under Section 3(c)(5)(C). In addition to CMOs and REMICs, the SEC stated that "exemptive orders have been issued to special purpose corporations organized by home builders that wish to issue, among other things, bonds secured by pledges of mortgage loans on single family residences constructed by the builders, called ‘builder bonds.’"

At the time of the Protecting Investors report, the SEC noted that "[t]he Commission has issued approximately 125 orders under section 6(c) exempting structured financings backed by mortgage-related assets." 514

14. Rule 3a-7

Following the enactment of SMMEA, “the Commission since has adopted Rule 3a-7 under the 1940 Act, which provides that structured financings, including issuers of mortgage-backed securities, that meet specified conditions will not be deemed to be investment companies.” 515 Although this article does not contain a detailed discussion of Rule 3a-7, there is such a discussion in Ch. 30 of the Rosenblum treatise.

15. Satisfying the 25% Real Estate Related Assets Test

As discussed above, the 25% Real Estate Related Assets test may be reduced by the amount that the 55% Qualifying Interests test is exceeded. “Neither the [SEC] nor the Staff appear to have defined the term ‘real estate related assets.’” 516 Nonetheless, “[t]he Staff has taken the position . . . that a loan will qualify as a real estate related asset if at least 55 percent of the fair market value of the loan is secured by real estate at the time the issuer acquires the loan.” 517

The [SEC] Staff also has taken the position that agency partial pool certificates (that is, certificates issued or guaranteed by agencies such as Fannie Mae, Ginnie Mae, or Freddie Mac that representing less than the entire ownership interest in a pool of

512. Id. at 73-74.
513. Id. at 74 n.272; see also, e.g., Am. Sw. Fin. Corp., Investment Company Act Release No. 12771, 26 SEC Docket 764, 764-65 (Oct. 29, 1982) (describing the attempt of a corporation dealing in mortgage-backed securities to seek SEC exemption from the 1940 Act under section 6(c)).
514. PROTECTING INVESTORS REPORT, supra note 343, at 74.
515. ROSENBLUM, supra note 204, § 15.7, at 427.
516. Id. § 15.4.3, at 422.
517. Id. (citing NAB Asset Corp., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 820 (June 20, 1991)).
mortgages) and so-called residual interests—for example, interests in securities backed by mortgages or other interests in real estate, or interests in companies that invest in mortgages or other interests in real estate—are real estate related assets.\footnote{\textsc{Rosenblum}, supra note 204, § 15.4.3, at 422.}

D. \textit{Section 3(c)(6)}

Section 3(c)(6) excepts from the definition of an investment company “[a]ny company primarily engaged, directly or through majority-owned subsidiaries, in one or more of the businesses described in . . . [Sections 3(c)(3), 3(c)(4), or 3(c)(5)], or in one or more of such businesses (from which not less than 25 per centum of such company’s gross income during its last fiscal year was derived) together with an additional business or businesses other than investing, reinvesting, owning, holding, or trading in securities.”\footnote{Investment Company Act of 1940 § 3(c)(7), 15 U.S.C. § 80a-3(c)(6) (2006).} Section 3(c)(3) generally relates to banks and savings and loans, while 3(c)(4) generally relates to any person who has substantially all of his business confined to making small loans, industrial banking or similar businesses.

“The principal effect of this Section is to except from the 1940 Act diversified operating and holding companies that otherwise would be deemed to be investment companies under any of the definitions in Section 3(a) of the 1940 Act, as well as bank holding companies, insurance company holding companies, and similar holding companies.”\footnote{\textsc{Rosenblum}, supra note 204, § 16.1, at 431.} A full discussion of Section 3(c)(6) is beyond the scope of this article.\footnote{For a more complete discussion of Section 3(c)(6), see \textsc{Rosenblum, supra note 204, § 16.}}

The SEC has stated that the term “primarily engaged” in a business means that “at least 55% of a company’s assets are employed in, and 55% of a company’s income is derived from, that business.”\footnote{Id. § 16.2, at 432.} Rosenblum notes that the SEC’s current interpretation of Section 3(c)(6) would exempt a fund if

that company devotes at least 55 percent of its assets to, and derives at least 55 percent of its income from, a combination of (1) one or more of the businesses described in Sections 3(c)(3), 3(c)(4) and 3(c)(5), from which the company derived at least 25 percent of its gross income during its last fiscal year, and (2) an additional business or businesses other than investing,
reinvesting, owning, holding, or trading in securities.\textsuperscript{523}

With respect to real estate funds, to the extent that an investment adviser structured a sufficient part of the fund’s operations so that it did not engage in “securities” transactions within the SEC’s current interpretation of Section 3(c)(6), but still satisfied the other conditions of Section 3(c)(6), the fund could potentially qualify for the Section 3(c)(6) exemption under the Investment Company Act even where it could not qualify under Section 3(c)(5)(C). Therefore, Section 3(c)(6) could potentially help expand the ability of certain real estate funds that were not heavily invested in “securities” to achieve an Investment Company Act exemption, in comparison with Section 3(c)(5)(C).

Presumably, Section 3(c)(6) would allow an Investment Company Act exemption if the fund devotes at least 55% of its assets to, and derives at least 55% of its income from, a combination of (1) 3(c)(5), from which the company derived at least 25% of its gross income during its last fiscal year, and (2) an additional business or businesses other than investing, reinvesting, owning, holding, or trading in securities.

Presumably, under Section 3(c)(6), assuming that the fund was invested in an additional business or businesses other than investing, reinvesting, ownership, holding or trading in securities, the fund would need to own Qualifying Interests equal to 55% multiplied by 55%, or 30.25%. Real Estate Related Assets would presumably be adjusted based on the 55% multiplier, down to 13.75%. However, an entity may need no-action relief to confirm this view. Finally, whether or not a non-investment business existed would most likely be determined in a similar manner as under Section 3(b)(1) and Section 3(b)(2), discussed above.

E. Section 3(c)(9)

Section 3(c)(9) of the Investment Company Act excepts from the definition of an investment company “[a]ny person substantially all of whose business consists of owning or holding oil, gas, or other mineral royalties or leases, or fractional interests therein, or certificates of interest or participation in or investment contracts relative to such royalties, leases, or fractional interests.”\textsuperscript{524}

Since most private equity real estate funds are not oil and gas funds, this article does not elaborate on the compliance framework for Section 3(c)(9). Those interested in using Section 3(c)(9) should see the

\textsuperscript{523} \textit{Id.} § 16.3, at 434.

\textsuperscript{524} 15 U.S.C. § 80a-3(c)(9).
Rosenblum treatise, Investment Company Determination under the 1940 Act: Exemptions and Exceptions.\textsuperscript{525}

CONCLUSION

The Dodd-Frank Act will regulate many private equity advisers more heavily, which private equity advisers will likely argue to be inconsistent with the historical reasons for the light regulation of private equity, which led to the fluidity of private equity investment strategies and higher investment returns.

This paper argues that the Dodd-Frank Act attempted to prevent against systemic risks in response to the financial crisis of 2008, but poses over-regulation dangers on private equity real estate, even though regulators have acknowledged that an inappropriate level of regulation on private equity was not the cause of the financial crisis. In particular, the author presents compelling evidence that private equity real estate does not give rise to systemic risk concerns, yet Title IV of the Dodd-Frank Act threatens to subject private equity real estate advisers to tightened regulations, which impose considerable compliance costs and which could be particularly burdensome for small and/or start-up firms. Apart from all this, too much regulation could potentially cause private equity funds that cannot cope with the compliance costs and efforts to relocate to jurisdictions where regulation is less intense, which is not advantageous for the U.S. economy.

Applying the Volcker Rule against PERE would cut off a significant source of capital to PERE funds, even though banks aren’t a gigantic percentage of PERE’s investors. This is problematic, since PERE has had a significant role in paving the way to the recovery of the real estate markets after various financial crises.\textsuperscript{526}

In the face of these changes, this paper predicts that private equity advisers will not only comply, but also adapt. This said, this article also predicts that traditional private equity investment advisers, who largely advise about investments in non-real estate securities and whose funds hence rely on (c)(1)/(c)(7) Investment Company Act exemptions, will have a very limited ability to adapt to Dodd-Frank and will have to comply in a rather straightforward way.

However, this article predicts a more flexible adaptive approach for private equity real estate investment advisers, rather than rigid compliance

\textsuperscript{525}. Rosenblum, supra note 204.

\textsuperscript{526}. “As in the 1990s, the recovery [after the financial crisis of 2008] in the commercial property market was once again led by private equity funds and REITs seeking to buy distressed assets at bargain prices or to place capital into safe, income-generating and potentially inflation-hedging assets.” Geltner et al., supra note 46, at 148.
with the new rules. In order to alleviate over-regulation dangers for private equity real estate, especially in light of the fact that private equity real estate does not pose systemic risk concerns and possesses typically only moderate investment risks, this article sets forth new paths for private equity real estate advisers navigating through the new regulatory landscape. In particular, this article predicts that private equity real estate will potentially be able to legitimately (1) sidestep the Advisers Act, the Investment Company Act and the Volcker Rule by avoiding advice about “securities,” and (2) sidestep Dodd-Frank Act provisions that regulate advisers to (c)(1)/(c)(7) Investment Company Act exempt funds (notably Form PF and the Volcker Rule) by advising non-(c)(1)/(c)(7) exempt funds. The author believes that these new paths will be acceptable to the regulators, given the long-standing tradition of regulators classifying non-securities real estate investments as falling outside the scope of the Advisers Act, and given both the absence of systemic risk concerns and the typically only moderate investment risks of private equity real estate in general. The absence of private equity real estate systemic risk concerns is further evidenced by the gesture of the regulators in finalizing Form PF, which exposes certain registered investment advisers to report risk exposure statistics. However, there is no indication that this applies to private equity real estate funds that utilize non-(c)(1)/(c)(7) exemptions.

From the angle of policy analysis, this article first examined private equity real estate along three axes of potential systemic contributors by analogy to a physical network of nodes, and ruled them out one by one. The article then compared private equity real estate funds to hedge funds, and showed that private equity real estate doesn’t generate systemic risk concerns because private equity real estate funds don’t typically invest in derivatives, have a relatively small aggregate size, don’t typically use banks and investment banks as prime brokers, typically don’t do short selling, typically utilize only moderate leverage, typically don’t invest heavily in mortgage-backed securities and typically possess only moderate investment risks. These facts support the argument that these new routes through the regulatory landscape would be positive for society at large and ease over-regulation dangers.

In regard to the Volcker Rule, the author urges the joint agencies charged with issuing a final rule on the Volcker Rule to limit their discretion and not apply the Volcker Rule against PERE funds utilizing non-(c)(1)/(c)(7) Investment Company Act exemptions.

The article argues that (1) PERE itself carries no characteristics that tend to generate systemic risks, (2) the possibility of a risk “ripple effect” propagating from PERE through banks to the markets is low, given that, (a) PERE investments typically pose moderate investments risks, except for investments in land, which not all PERE funds invest in, and (b) the
The interconnection between banks and PERE is quite weak due to the relatively tiny size of the banks’ investments in PERE and the minuscule percentage that PERE occupies in the banks’ investment portfolios, and isn’t likely to become strengthened in the future. Although some naysayers might believe that leverage and land investments could potentially create ripple effects, such effects would clearly be mitigated by the absence of other systemic risk concerns, in particular given the fact that the interconnectedness between PERE and banks isn’t sufficiently strong to give rise to systemic effects.

Private equity real estate advisers should work with their counsel on how to secure compliance with these exemptions. Private equity real estate advisers seeking to explore these trailblazing possibilities may wish to seek SEC staff no-action relief to confirm the legal bases for these possibilities, but this article asserts that the SEC should accept these possibilities as part of the new regulatory landscape for private equity real estate in light of the policy reasons expressed in this article. If the SEC were to formally recognize these new paths, it would increase transactional certainty for private equity real estate and foster their freedom of choice to select the best regulatory path, which would in turn avoid the dangers of over-regulation for private equity real estate.

In this stagnant time of our economy, regulators should strive to find the optimal balance between business freedom and regulation. As discussed earlier, over-regulation—notably private equity real estate over-regulation in this case—could potentially harm the economy and have other harmful effects on society. Regulators and society will hopefully recognize the absence of systemic risks posed by private equity real estate and the great likelihood that the Dodd-Frank Act might over-regulate private equity real estate if these new paths through the regulatory landscape are not recognized. The author hopes that this article will lead to a more prosperous and more balanced economy, where the true art of building a flourishing macro-society lies.