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U.S. Legislative Update: Why Real Estate Fund Managers Should Monitor Congressional Bills Targeted at Hedge Funds

Background

The financial reform legislation currently before the U.S. Congress, including the bill passed Friday by the House of Representatives,¹ targets hedge fund managers, but in doing so would strip away an exemption from U.S. investment adviser registration rules that is important to real estate fund managers as well. If real estate-focused fund managers were required to become registered investment advisers under the U.S. Investment Advisers Act of 1940 (the "Advisers Act"), they would find that compliance with the Advisers Act can impose significant burdens and expense.

Current Regulatory Status

The Advisers Act defines an "investment adviser" to include, among other things, a person that, for compensation, engages in the business of advising others on investing in securities.² A real estate fund manager may be an "investment adviser" if, as part of its business, it receives compensation for managing a fund's investments in securities.

Certain assets, such as a fee simple interest in real estate assets, are not viewed as "securities" for this purpose.

Even if managing such non-security assets is the primary business of a real estate fund manager, however, a portion of the manager's business may involve advice on securities investing. For example:

- Management of the cash flow from investors' contributions prior to the fund's investment in real estate assets, or of the cash flow from investments prior to payment of expenses or distribution to investors, likely involves the acquisition of securities.
- If a fund's investment program involves any lending or debt acquisition activities (such as direct lending, acquiring mezzanine debt or acquiring participation interests in loans), such activities can also be deemed under the Advisers Act to involve the acquisition of securities.
- If a fund acquires limited partnership or membership interests in a real estate asset, securities issued by a real estate investment trust (REIT), mortgage-backed securities, the shares of operating companies in the real estate sector or other indirect interests in real estate assets, these are generally investments in securities for purposes of the Advisers Act.

Significantly, there is no "primary business" exception offering a carve-out for managers with a primary business of advising on assets other than securities. Nor is there a de minimis exception for managers investing, say, less than 5% of their assets under management in securities. For these reasons, most real estate fund managers likely

¹ The version of the bill that was introduced in the House can be found at http://docs.house.gov/rules/finserv/111_hr_finsrv.pdf (the part titled "Private Fund Investment Advisers Registration Act" begins on page 1021). Amendments to that proposed bill, which are included in what was recently passed by the House, can be found at the Library of Congress's "Thomas" web site, located at <http://thomas.loc.gov>. The bill is H.R. 4173, "The Wall Street Reform and Consumer Protection Act of 2009."

² Section 202(a)(11) of the Advisers Act.

fall within the definition of “investment adviser” under the Advisers Act.

The exemption from registration under the Advisers Act historically relied upon by real estate fund managers that also engage in securities-related investment management to one degree or another is the so-called “private adviser exemption.” That exemption is currently available to most advisers that have had fourteen or fewer investment advisory clients during the preceding twelve months – with a fund “counting” as one client under most circumstances.³ Unfortunately, it is exactly this private adviser exemption that has been the cornerstone of the unregistered hedge fund management industry. As a consequence, the effort to regulate hedge fund managers is likely to eliminate this exemption altogether – with real estate-focused fund managers swept along for the ride.⁴ Unless a new exemption becomes available, most real estate fund managers would be required to register under the proposed legislation as it currently stands.

The Proposed Legislation and Follow-on Rulemaking

On October 1, 2009, Rep. Paul E. Kanjorski issued a slim discussion draft of legislation titled *The Private Fund Investment Advisers Registration Act*. It provided as a core item for the complete repeal of the private adviser exemption, which would mean that any investment adviser having assets under management above a de minimis amount would be required to register with the U.S. Securities and Exchange Commission (“SEC”), regardless of the number of the adviser’s clients. Smaller advisers would be required to register under any applicable state law. Following mark-up in committee,

Rep. Kanjorski’s bill emerged with an exemption from Advisers Act registration for advisers to venture capital funds (as the SEC would define them), although venture capital fund managers would nonetheless become subject to certain new reporting and recordkeeping requirements under the Advisers Act.⁵ These provisions can be found in the comprehensive bill passed by the House last Friday, December 11, 2009, which now runs to well over 1,000 pages.

As for the U.S. Senate, Sen. Christopher J. Dodd similarly issued on November 10, 2009 a comprehensive draft financial reform package covering a wide range of topics. It has about one dozen pages that correspond to Rep. Kanjorski’s original discussion draft.⁶ Notably, unlike the version passed by the House, the Senate version would exempt advisers to private equity funds and managers of “family offices” (again, as the SEC would define them) from Advisers Act registration requirements, although private equity fund managers would become subject to certain new reporting and recordkeeping requirements under the Advisers Act. As currently drafted, the Senate bill’s exemptions would be available regardless of the number of clients advised.

Both proposals would have broad extraterritorial effect. Fund managers, even if based overseas and investing overseas, would be required to register under the Advisers Act if the amount of fund assets attributable to U.S. clients exceeds a particular threshold.

The next steps for both bills are uncertain, as these Advisers Act proposals represent a small part of a much larger legislative initiative. Thus, for example, any extended debate on the role of the Federal Reserve or on systemic risk regulation is likely to have the collateral effect of delaying consideration of fund manager-focused reforms. There is, however, no organized opposition to

³ Section 203(b)(3). This exemption is only available if the fund manager does not hold itself out generally to the public as an investment adviser and does not serve as investment adviser to a fund registered under the U.S. Investment Company Act of 1940 (the “Investment Company Act”).

⁴ Our firm issued last week a client publication with respect to similar developments in the European Union, available at <http://www.shearman.com/update-on-the-proposed-european-aifm-directive-council-and-parliament-publish-draft-amendments-12-08-2009/>.

⁵ See our previous client alert (dated October 6, 2009) available at <http://www.shearman.com/new-developments-on-us-legislative-proposals-for-the-registration-of-advisers-to-private-funds-10-06-2009/>.

⁶ The text of the Senate discussion draft is available at http://banking.senate.gov/public_files/AYO09D44_xml.pdf (the part titled “Regulation of Advisers to Hedge Funds and Others” begins on page 291).

SEC registration of hedge fund managers, so that the eventual repeal of the private adviser exemption appears inevitable. It is, in other words, just a matter of time.

What can real estate fund managers hope for in the interim? Most desirable would be to see the introduction into the final legislation of a carve-out specific to certain real estate fund managers. Alternatively, if the final legislation includes an exemption for private equity fund managers, it may well be that some real estate fund managers find flexibility there. Real estate funds are similar to private equity funds in several respects, even if the two kinds of funds ordinarily implement dissimilar investment programs. Among other similarities, such funds commonly have an initial offering and no continuous offering, accept capital on a “capital commitment” basis, have an investment period during which those commitments are drawn down, have a term of perhaps 6 to 12 years rather than perpetual operations, and typically allow no voluntary redemptions during that term. Not all real estate funds, of course, fit within that description.

The body that ultimately will set the scope of any such exemption is likely to be the SEC, so SEC rulemaking implementing the final legislation must be monitored closely. Under applicable administrative procedures, SEC rules are adopted only after a public comment period allowing the opportunity for any interested party to make its case before the regulator. Industry submissions of carefully prepared and informative materials may be well-received by the SEC as it wades through public comments.

What Advisers Act Registration Means

If no available exemption emerges, it may be necessary for real estate fund managers to become familiar with the Advisers Act and its requirements. By way of overview, an SEC-registered investment adviser is subject to relatively few direct limitations on investment or trading strategies, but must comply with an elaborate set of infrastructure requirements and submit to ongoing SEC inspections and oversight. A large body of statutory

provisions, rules, SEC statements, SEC staff no-action letters and other guidance must be consulted at various times and in connection with various activities of the manager.

Among the more burdensome requirements, a registered investment adviser must prepare a comprehensive compliance program, engage a chief compliance officer, and monitor day-to-day regulatory compliance.⁷ Its personnel must comply with a personal trading code of ethics that requires the personnel to, among other things, provide the adviser with reports of securities they personally hold and trade. The adviser must also prepare a public registration filing and update it periodically.

Once a manager registers as an investment adviser, its receipt from a real estate fund of a promoted interest (performance-based compensation) may be affected because generally the Advisers Act provides that only those investors that fit the definition of “qualified client” may be subject to a registered adviser’s performance-based compensation.⁸ The advertising of the performance of a fund or its investment adviser would be subject to certain rules, technical requirements and prohibitions. There are also rules on dealings with affiliates and direct dealings between the adviser and its clients.

⁷ A sense of what it means for a registered investment adviser to implement a compliance program can be found in two previous client alerts available at http://www.shearman.com/am_0304/ and http://www.shearman.com/am_0305/.

⁸ Rule 205-3 under the Advisers Act defines “qualified client” to include (i) a client that has at least \$750,000 under the management of the investment adviser, (ii) a client that, upon entering into the advisory relationship or investing in the fund, the adviser reasonably believes has either a net worth of more than \$1,500,000 (including assets held jointly with a spouse) or is a “qualified purchaser” under the Investment Company Act, or (iii) certain executives and investment advisory personnel of the investment adviser. A real estate fund that, for example, relies on Section 3(c)(1) of the Investment Company Act to avoid registration as an investment company may have investors who are not “qualified clients.”

Conclusion

Real estate fund managers worldwide should assume that they could be affected by current U.S. legislative initiatives targeted at hedge funds. This small part of the overall financial reform package described above will not make many headlines, but these bills before Congress and follow-on SEC rulemaking need to be monitored closely. Given the fluid environment, education efforts may be useful to assure that policymakers understand – and limit – the spill-over effects of well-intentioned legislation on the real estate investment management community.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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