

REAL ESTATE PROGRAMS — AVOIDING THE SCOPE OF THE INVESTMENT COMPANY ACT

By: Richard P. Cunningham, Jr., Esq. and Thomas G. Voekler, Esq.

Sponsors of real estate investment programs, which broadly includes public and private REITs, real estate limited partnerships, note programs, debt and lending funds and other fund structures, need to be cognizant of the scope of the Investment Company Act of 1940, as amended, and its possible application to their operations. For purposes of the 1940 Act, an “investment company” is any issuer that engages primarily in the business of investing, reinvesting, or trading in securities. While some sponsors may be inclined to disregard this definition as inapplicable to the daily operations of a real estate program, disregard is a trap for the unwary. The reach of the 1940 Act is broad, and it establishes a regulatory framework that imposes extensive substantive requirements on any company required to register. The failure to successfully navigate the exemptions and exclusions provided by the 1940 Act could lead to onerous regulation and prohibitive costs on the real estate program.

To avoid registration under the 1940 Act, a real estate program should generally seek to rely on one or more of three statutory exclusions and one regulatory exemption.

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PRIVATE INVESTMENT COMPANIES

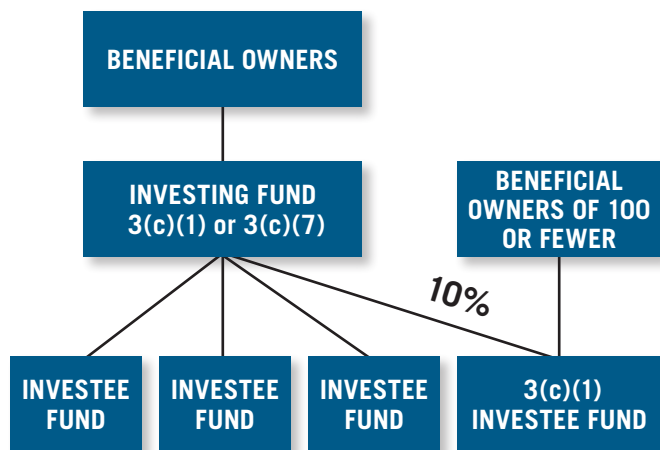
Section 3(c)(1) of the 1940 Act excludes from the definition of an “investment company” (and, thus, exempts from registration) any “private investment company,” which is an entity whose outstanding securities are beneficially owned by not more than 100 persons and that is not making and does not propose to make a public offering of its securities.¹ “Outstanding securities” has been broadly defined by the Securities and Exchange Commission. Real estate programs relying on Section 3(c)(1) should be mindful to take into account the beneficial owners of all series and classes of its securities, whether debt (other than short term paper) or equity, voting or non-voting, in monitoring the 100-owner limit. This 100-owner limit can substantially limit the amount of capital raised by a real estate program because of the limit on the number of sources for that capital. Sponsors should note that Section 3(c)(1) is generally not useful in the long term for an entity electing to be taxed as a REIT for federal income tax purposes, because Section 856(a)(5) requires the REIT to have more than 100 beneficial owners for its first full taxable year.

¹ For a program seeking to rely on either Sections 3(c)(1) or 3(c)(7) and which is conducting a private offering under Section 4(2) or Regulation D under the Securities Act of 1933, particular care should be given to ensure that a prohibited general solicitation does not occur. A general solicitation under these circumstances could technically result in a public offering, and compound potential Securities Act violations with 1940 Act registration issues.

A real estate program relying on Section 3(c)(1) may be substantially affected by certain look-through rules that are found in Section 3(c)(1)(A) of the 1940 Act. The 1940 Act limits the use of multi-tiered pooled investment vehicles to avoid the 100-owner limit by looking through an entity (an “Investing Fund”) that invests in a 3(c)(1) sub-fund (a “3(c)(1) Investee Fund”) in certain circumstances, and counting the beneficial owners of the Investing Fund’s outstanding securities as if they were direct beneficial owners of outstanding securities of the 3(c)(1) Investee Fund. Under Section 3(c)(1)(A) of the Act, each beneficial owner of outstanding securities of an Investing Fund is counted as a beneficial owner of outstanding securities of a 3(c)(1) Investee Fund for the purpose of the 100-owner limit, if both of the following conditions exist:

1. the Investing Fund is a registered investment company or a fund relying on either Section 3(c)(1) or Section 3(c)(7); and
2. the Investing Fund owns 10% or more of the 3(c)(1) Investee Fund’s outstanding voting securities.

The look-through test would apply as set forth in the example below. Because the Investing Fund is either a 3(c)(1) or 3(c)(7) fund and owns 10% of the outstanding voting securities of the 3(c)(1) Investee Fund, the beneficial owners of the Investing Fund will also be counted as beneficial owners of the 3(c)(1) Investee Fund.



The application of the look-through test has significant implications for the 3(c)(1) Investee Fund. If a 3(c)(1) Investee Fund’s beneficial owner count is pushed over

the 100-owner limit, then the 3(c)(1) Investee Fund will lose its ability to rely on Section 3(c)(1) and become subject to registration under the 1940 Act in the absence of another exclusion. Thus, a real estate program relying on Section 3(c)(1) should either (1) limit an Investing Fund’s investment to less than 10% of the real estate program’s outstanding voting securities or (2) assume that each of an Investing Fund’s owners will be deemed to be a beneficial owner, and therefore counted towards the 100-owner limit, of the real estate program. Sponsors should also note that limited partnership and limited liability company interests may constitute “voting securities” for purposes of the look-through test. In any event, a real estate program choosing to rely on Section 3(c)(1) must have adequate procedures in place to ensure it does not exceed the 100-owner limit, such as a way to monitor when investment companies subscribe as investors in the program and any inheritance and gift transfers.

QUALIFIED PURCHASERS

Section 3(c)(7) of the 1940 Act excludes a real estate program from the definition of an investment company if all of the beneficial owners of its outstanding securities are “qualified purchasers” and if it does not make or propose to make a public offering of its securities.

A “qualified purchaser” is defined as:

1. an individual who holds at least \$5,000,000 in “investments”²;
2. a family-operated company that owns at least \$5,000,000 in investments;
3. a trust that is not a family-operated company and that is not formed for the specific purpose of investing in the 3(c)(7) fund and of which each trustee who makes investment decisions on behalf of the trust and each contributor is a qualified purchaser; or
4. a person, acting for such person’s own account or the account of other qualified purchasers,

² “Investments” means seven types of instruments: (1) securities, except controlling interests in all but certain issuers; (2) real estate held for investment purposes; (3) commodity interests held for investment purposes; (4) physical commodities held for investment purposes; (5) financial contracts entered into for investment purposes; (6) unfunded capital commitments or similar unfunded binding commitments to acquire an interest in a Section 3(c)(7) fund, a Section 3(c)(1) fund, or a commodity pool; and (7) cash and cash equivalents held for investment purposes.

who owns or invests on a discretionary basis at least \$25,000,000 in investments.

Pursuant to Rule 2a51-3 under the 1940 Act, a “qualified purchaser” also includes a company not meeting the above requirements as long as all of the beneficial owners of the securities of that company are qualified purchasers.

REAL ESTATE COMPANIES

Section 3(c)(5)(C) of the 1940 Act excludes a real estate program from the definition of an investment company if it is “primarily engaged” in purchasing or acquiring mortgages and other liens on, and interests in, real estate. It is one of the most widely relied upon exceptions for real estate programs.

The SEC staff has granted favorable no-action relief for programs seeking exemption from registration under, or the application of, the 1940 Act, if: (1) at least 55% of the real estate program’s assets consist of mortgages and other liens on or interests in real estate, and (2) the remaining 45% of its assets consist primarily of real estate-related investments. The SEC staff has agreed that the test that at least 45% of a program’s assets consist “primarily of real estate-related investments” means that at least 55% of the 45% must be primarily in real estate-related assets and the remaining assets may be investments that are entirely unrelated to real estate. This permits a real estate program to put up to 20% of its total assets in interests unrelated to real estate, such as stocks, U.S. government securities, commercial paper, etc. Sponsors and advisors should note that the determination of “primarily engaged” is an asset test and not an income test. It is also important to note that these percentage tests are mainly relevant with respect to the ability of a real estate program to receive no-action relief from the SEC staff. While the SEC staff may not be willing to grant no-action relief where these percentage tests are not met, in many cases a real estate program with more than 50%, but less than 55%, of its assets invested in mortgages or real estate may nonetheless be able to rely on Section 3(c)(5)(C).

To qualify for this exclusion, a Fund need not be an active real estate investor. A passive pool of mort-

gages can meet this requirement. “Real estate” under Section 3(c)(5)(C) includes:

1. a fee interest in real estate;
2. a leasehold interest;
3. a note fully secured by a mortgage on real estate³; and
4. GNMA, FNMA and FHLMC certificates comprising an undivided interest in an entire pool of mortgages backing the certificates (i.e., “whole-pool” GNMA, FNMA or FHLMCs).

According to the SEC staff, this provision generally would not include “partial-pool” GNMA certificates (i.e., one of a number of certificates each of which represents an undivided, proportionate interest in the entire pool of mortgages backing the certificates).

“Real estate” may also not include a limited partnership interest in a partnership primarily engaged in acquiring and owning interests in real estate, in the absence of other factors. The SEC staff requires that the real estate program have the power to remove and replace the general partners in the partnership, with or without cause. In addition, if the real estate program invests in an entity that owns the real estate assets, it must be considered a “majority-owned subsidiary.” This is generally defined to be an entity for which 50% or more of its outstanding voting securities are owned by the real estate program (or one of its subsidiaries). Whether an entity is a majority-owned subsidiary often turns on whether interests in it constitute “voting securities,” which is often a factual determination. Generally, interests or relationships that give the ability to control or influence an entity’s operations or management may be considered “voting securities.” A holder of non-voting securities may be considered to hold the equivalent of a “voting security” if the holder possesses an economic interest that gives it the power to exercise control over the issuer’s management.

According to the SEC staff, Section 3(c)(5)(C) does not include collateralized loans or secured borrowings where the security may be in the form of a mortgage interest but the proceeds are used for some purpose

³ The SEC staff has held that a mezzanine loan that is secured by a pledge of the ownership interests in the borrowing entity would be a valid real estate asset.

other than developing, refinancing or investing in the underlying real property. Also, where an interest, such as units in a group trust, do not give the holder power to exercise a controlling influence over the trustee or manager of the trust, nor any ability to select, remove or replace the trustee or manager, no “voting security” exists. Similarly, the SEC staff generally does not view options and convertible securities to be “voting securities.”

FINANCING SUBSIDIARIES

Real estate programs, and notes programs in particular, may be able to rely on Rule 3a-5 promulgated under the 1940 Act to avoid registration as an investment company. Rule 3a-5 excludes from the definition of an investment company a real estate program (1) organized primarily to finance the business operations of a parent company (or companies under its control) and (2) all of whose equity securities (other than certain non-voting preferred stock and directors’ qualifying shares) are owned by the parent company (or companies under its control). Although the rule defines a “finance subsidiary” as a corporation, the SEC staff has permitted limited liability companies and business trusts to rely on the rule.

The rule requires that:

1. any debt securities of the finance subsidiary issued to or held by the public must be unconditionally guaranteed by the parent company as to the payment of principal, interest and premium (if any);⁴
2. the finance subsidiary must, as soon as practicable, invest in or loan to its parent or a company controlled by the parent at least 85% of any cash and cash equivalents raised by the finance subsidiary through offerings of its debt or non-voting preferred stock or through other borrowing;
3. the parent must guarantee unconditionally the non-voting preferred stock of its finance subsidiary as to the payment of dividends and payment of the liquidation preference in the event of liquidations; and

4. the finance subsidiary may not invest in, reinvest in, own, hold or trade in securities other than government securities, securities of its parent company or a company controlled by its parent company or debt securities exempt pursuant to Section 3(a)(3) of the Securities Act of 1933 (i.e., certain securities for short-term financing).

Rule 3a-5 requires that, in the event of default on the debt or nonvoting preferred stock issued by a finance subsidiary, the security holders may directly sue the parent without first proceeding against the subsidiary. The SEC staff has determined that, under appropriate circumstances, money market funds, demand deposits, certificates of deposit and other similar time deposits of foreign banks as well as repurchase agreements with respect to U.S. government securities are the type of short-term investments permitted by Rule 3a-5.

The exclusion is available if neither the parent company nor any company controlled by the parent that is being financed is an investment company for purposes of Section 3(a) or is excepted or exempted by order from the investment company definition under Section 3(b) or by the rules adopted under Section 3(a). The SEC staff has declined to provide no-action relief with respect to a finance subsidiary where the parent company or the company controlled by the parent that is being financed may be relying on the exception from the investment company definition in Section 3(c) of the 1940 Act (such as the exceptions discussed above). Thus, for sponsor entities that have subsidiaries engaged in real estate investment activities, it is important that the financing subsidiary make loans or equity investments in an operating company, such as the sponsor, that would be able to claim that it is excluded from the definition of an investment company set forth in Section 3(a) or is excluded from that definition under Section 3(b).

Richard P. Cunningham, Jr. and Thomas G. Voekler are attorneys at the law firm of Hirschler Fleischer, A Professional Corporation. They are members of the firm’s Real Estate Securities and Private Equity Group and focus on public and private securities offerings. They can be reached at rcunningham@hf-law.com and tvoekler@hf-law.com.

⁴ The SEC staff has held that where the debt is offered in a private placement, this prong does not need to be met.