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MEMORANDUM

DODD-FRANK AND THE REGISTRATION OF REAL ESTATE ADVISERS

JUNE 27, 2011

The Dodd-Frank Consumer Protection and Wall Street Reform Act, enacted on July 21, 2010 (the "Dodd-Frank Act"), fundamentally reshapes the scope of investment adviser registration under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). An adviser that provides advice with respect to real estate and real estate-related investments (referred to herein as a "real estate adviser") should promptly consider whether it will be required to register as an investment adviser with the Securities and Exchange Commission (the "SEC") or one or more states as a result of the changes made by the Dodd-Frank Act. The SEC recently postponed the compliance date for the registration obligation; as a result, an adviser required to register as a result of the Dodd-Frank Act must register by March 30, 2012.

In this article, we attempt to assist National Multi Housing Council/National Apartment Association ("NMHC/NAA") members in assessing whether they have an obligation to register as an investment adviser, by discussing:

1. Why real estate advisers must now consider investment adviser registration obligations,
2. When a real estate adviser might be an investment adviser,
3. If a real estate adviser is an investment adviser, whether it must register with the SEC or with one or more state regulators, and
4. The consequences of having to register as an investment adviser with either the SEC or one or more states.

This article is intended only as a broad discussion of the topics addressed. To prepare for this radical change in law, we recommend that NMHC/NAA members promptly assess their operations and investment activities in order to determine whether they may be subject to adviser registration. Such a determination may require a member to consult securities counsel. We are happy to address any specific questions or circumstances applicable to individual NMHC/NAA members. If you have any questions regarding this memorandum, please do not hesitate to contact Cary Meer at (202) 778-9107 or Diane Ambler at (202) 778-9886, partners at K&L Gates LLP, Washington, D.C.

I. I Never Thought About Adviser Registration Before - Why Must I Now?

Many real estate advisers have never previously considered whether they might be subject to investment adviser registration; as a result, some understandably are asking why they must consider the issue now. After all, it may not be apparent how a manager of real estate and real estate-related assets would need to be concerned with Advisers Act compliance. The difference between being deemed an investment adviser and not is highly fact specific and can depend on structural issues as well as the make-up of the assets under management.

In the past, real estate advisers may have unknowingly met the definition of an investment adviser but fallen within an exemption from federal and state investment adviser registration, commonly referred to as the "private adviser exemption."[1] The private adviser exemption provides an exemption from Advisers Act registration for an adviser that would otherwise be required to register if, among other things, (1) during any rolling 12-month period the adviser had fewer than 15 clients, and (2) it does not "hold itself out" to the public as an investment adviser.[2] Among other things, the Dodd-Frank Act repeals the "private adviser exemption" effective July 21, 2011; although, as noted above, the SEC has postponed the obligation to register as a result of the repeal. As a result of the repeal of the private adviser exemption, a wide range of entities that either intentionally or unknowingly have been operating as advisers under this exemption must now assess their potential registration obligations, including certain real estate advisers and advisers to many hedge, private equity and other types of funds.

II. When Might a Real Estate Adviser be an Investment Adviser?

The Advisers Act defines "investment adviser" very broadly, and most state securities (or "blue sky") laws include a substantially similar definition.[3] A real estate adviser generally will meet most of the criteria of the investment adviser definition. The main consideration for a real estate adviser in determining if it is an investment adviser is whether or not the real estate adviser is providing advice with respect to "securities."[4] Subject to certain exemptions and specific circumstances, a real estate adviser is an investment adviser if it advises clients with respect to securities.

It is often extremely difficult to generalize types of real estate investments and real estate holding structures as either constituting securities or not, given the variety of forms such investments and structures take and the regulatory uncertainty in this area. The analysis depends on the specific facts

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[1] Advisers that satisfy this exemption are nevertheless subject to antifraud restrictions under the Advisers Act.

[2] The private adviser exemption is currently found in Section 203(b)(3) of the Advisers Act and Rule 203(b)(3)-1 thereunder. In addition to the factors listed, an adviser relying on the private adviser exemption must also not serve as adviser to an investment company registered under the Investment Company Act of 1940, as amended ("1940 Act") (such as a mutual fund or closed-end fund), or a company that had elected to be registered as a business development company under the 1940 Act.

[3] Section 202(a)(11) of the Advisers Act defines "investment adviser," subject to certain exclusions, as:

> "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities . . . ."

[4] "Security" is defined in Section 202(a)(18) 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, guaranty of, or warrant or right to subscribe to or purchase any of the foregoing."

involved in a given organization and the level of flexibility desired to invest in real estate related securities or to structure co-investment arrangements among parallel funds or with third parties.

A. Real Property. Real property, of course, is not a security. As a result, a real estate adviser that advises its clients solely with respect to the purchase and sale of real property (whether alone or as part of a group) would not be providing advice with respect to securities. This conclusion does not change when one or more properties are held through one or more wholly-owned subsidiaries of a fund in a real estate holding structure.[5]

B. Mortgages. As a general rule, advising clients on making whole mortgage loans would not constitute securities-related advice.[6] Although a mortgage loan would be a "note," which is included in the definition of a "security" in the Advisers Act, not all financing transactions taking the form of a note involve the purchase or sale of a security. In *Reves v. Ernst & Young*, the Supreme Court developed a four-factor test (often referred to as the "family resemblance test") to determine when notes (such as mortgage loans) constitute securities.[7] The four factors are: (1) the motivations that would prompt a reasonable seller and buyer to enter into the transaction *(i.e.*, is the note for an investment or for some consumer or commercial financing purpose), (2) whether the plan of distribution of the notes involved "common trading for speculation or investment," (3) the reasonable expectations of the investing public (*i.e.*, would the public reasonably see the loans as investments or as consumer or commercial loans), and (4) whether there is some factor (such as the existence of another regulatory scheme) that significantly reduces the risk of the instrument, making application of the securities laws unnecessary.[8] Although *Reves* did not deal specifically with mortgages, the Supreme Court stated that it agreed with an earlier Second Circuit decision, which concluded that mortgages secured by property "are not properly viewed as 'securities.'"[9]

Nevertheless, the SEC has taken the position in certain instances that mortgages can constitute securities under certain circumstances, particularly under the 1940 Act.[10] Therefore, the issue is not entirely free from doubt. In addition, while mortgages are not securities in the hands of the originating

5 Such an arrangement could include, for instance, when a real estate fund holds individual properties through separate wholly-owned subsidiaries for liability compartmentalization. The interests in these subsidiaries would not be securities, not because the underlying assets are real property, but because, under the *Howey* test described below, the interests in the subsidiary would not constitute securities to the holder.

6 For this purpose, we do not discuss whether a mortgage might be a security under the 1940 Act. The SEC staff has long taken the position that the definition of security under the 1940 Act is broader than under the Securities Act of 1933, as amended (the "1933 Act"), or the Securities Exchange Act of 1934, as amended (the "Exchange Act"). *See, e.g., Bank of America Canada*, SEC No-Action Letter (July 25, 1983) (finding short-term paper to be a security under the 1940 Act even if it were not a security under the 1933 Act or the Exchange Act).

7 494 U.S. 56 (1990). Note that *Reves* was interpreting the definition of security for purposes of the 1933 Act and 1934 Act.

8 *Id.* at 66-67.

9 *Id.* at 65 (discussing *Exchange Nat. Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976)).

10 *See* pages 23-24 of Brief of Amici Curiae Securities and Exchange Commission, *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (No. 80-1562). *See also Ken Flood*, SEC No-Action Letter (March 2, 1984). *See also supra* note 6.

party, a purchaser on the secondary market is looking at the mortgage much more as an investment, like any other loan purchased in a secondary transaction, rather than as a financing transaction for property. This could change the analysis with respect to such a purchaser under certain of the *Reves* factors, particularly factors (1) and (2).

C. Lower-Tier Investment Vehicles. An adviser that recommends that its clients make or causes its clients to make passive investments in limited partnerships, limited liability companies or other entities that invest in real property or that originate or hold mortgages may be advising with respect to securities. Such an investment would likely constitute an "investment contract," which is one of the categories of securities enumerated in the Advisers Act definition. In *SEC v. W.J. Howey Co*., the Supreme Court defined an investment contract as "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 others."[11] A passive investor in such a lower-tier investment entity could be investing in an investment contract, even if the underlying holdings of that investment entity were real property, mortgages or other non-securities. The same considerations generally apply to securitizations, since these are in effect pools of mortgages or other instruments in which an adviser recommends that a client take or causes a client to take a passive interest in the form of a participation or note (not of the sort that *Reves* would deem a non-security).

An investment in a lower-level entity would not be a security, however, where a client (either directly or through the real estate adviser) exercises significant control over the operation of the entity. This could include investments in lower-level majority owned subsidiaries or joint ventures.

D. Mortgage-Backed Securities. Certain real estate related investments are undeniably securities, and are related to real estate only in the sense that they are backed by mortgages or other real estate related interests. This would include residential and commercial real estate mortgage-backed securities, stripped mortgage-backed securities, certificates issued by Ginnie Mae or guaranteed by Fannie Mae or Freddie Mac, and REIT securities. Advising clients with respect to such interests would involve advice with respect to securities.

The discussion above is intended only to be a general overview. For many real estate investments and holding structures, the determination of whether it constitutes a security often turns upon the specific features of the investment or structure and can even require an analysis of the motivations of the purchaser. It is often very difficult to make generalizations about when a real estate investment might constitute a security.

The following table briefly illustrates the spectrum:[12]

Type of Investment or Holding Structure	Status as a Security
Direct ownership of real property	Not a security
Ownership of real property through a wholly-owned subsidiary	Not a security
Interests in a majority-owned subsidiary that holds	Potentially a security

[11] 328 U.S. 293, 298-299 (1946).

[12] Note that some of the categories below overlap in the case of certain investments.

Type of Investment or Holding Structure	Status as a Security
real estate	
Interests in a less-than-majority-owned lower tier entity that holds real estate, such as limited partnership or membership interests in an entity holding a real estate asset	Potentially a security
Mortgage loans (originating)	Not a security
Mortgage loans (purchased on the secondary market)	Potentially a security
Interests or participations in an entity that holds a pool of mortgages	Likely a security
Investments in mezzanine debt, REIT stock, CDOs, ABS, CMOs and other stripped mortgage-backed securities	Likely a security

It is important to realize that, even if a manager's "primary business" is investment in non-security real estate assets, under the Dodd-Frank Act there is currently no *de minimis* exception from being an investment adviser where only a portion of the manager's business involves advice on securities investing. We can assist a real estate adviser in determining if its real estate holding structures or real estate investments constitute securities under the adviser's specific circumstances.

III. What Are the Implications of Being an Investment Adviser?

A real estate adviser that finds it is an investment adviser must determine whether it is required to register with the SEC under the Advisers Act or with one or more state regulators.[13] If an adviser is registered with the SEC, it is exempt from registration with state regulators, although it may need to send notice copies of its initial and updated Advisers Act filings to certain state regulators. If an adviser is not eligible to register with the SEC, it may, depending on its operations and clients, need to register with more than one state. Once an investment adviser has determined initially whether it must register with state or federal authorities, it must then determine whether an exemption is applicable.

A. Who Must Register with the SEC?

1. *$110 Million AUM Requirement*. After the registration obligation takes effect on March 30, 2012, an investment adviser must register with the SEC (or qualify for an exemption from registration) if it has more than $110 million in assets under management ("AUM").[14] An adviser that has less than $110 million in assets under management generally must register with one or more state regulators, rather than with the SEC, subject to certain exceptions discussed below.

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[13] As part of its reshaping of investment adviser registration, the Dodd-Frank Act also changes the division of labor between the SEC and the states in registering, regulating and inspecting investment advisers by revising the qualifications required for Advisers Act registration.

[14] Currently, this minimum amount is $25 million in AUM. The Dodd-Frank Act provided a $100 million threshold, but the SEC, by rule, increased this amount to $110 million. Notably, however, an adviser can elect to register with the SEC once it has $100 million in AUM, and, once an adviser is registered with the SEC, it need not withdraw its registration unless it drops below $90 million in AUM at a given year end.

The SEC recently adopted rules and guidance that governs how an adviser must calculate AUM for these purposes.[15] An adviser must include as AUM securities portfolios[16] for which it provides continuous and regular supervisory or management services,[17] regardless of whether the assets are proprietary assets, assets managed without compensation therefor or assets of non-U.S. clients.[18] In addition, an adviser would be prohibited from subtracting outstanding indebtedness and other accrued but unpaid liabilities, which remain in a client's account and are managed by the adviser (*i.e.*, an adviser may not deduct accrued fees, expenses or the amount of any borrowing). An adviser to a private fund[19] must include the value of any private fund over which that adviser exercises continuous and regular supervisory or management services, and must include any uncalled capital commitments made to the fund. In addition, a private fund adviser must use the market value (or, if market value is not available, the "fair value") of private fund assets in determining such value for purposes of calculating AUM.[20]

2. *Exemptions from $110 Million AUM Requirement.* An adviser with less than $110 million in AUM must register with the SEC if (1) the adviser is not required to be registered in the state in which it has its principal place of business,[21] or (2) even if required to be registered in such state, if the adviser would not be subject to examination as an investment adviser in the state in which the adviser has its principal place of business.[22]

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[15] *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Advisers Act Release No. 3221 (June 22, 2011).

[16] An account is a securities portfolio if at least 50% of the total value of the account consists of securities. Cash and cash equivalents may be treated as securities.

[17] An adviser provides continuous and regular supervisory or management services if (i) it has discretionary authority over and provides ongoing supervisory or management services with respect to the account; or (ii) it does not have discretionary authority but has ongoing responsibility to select or make recommendations based upon the needs of the client, as to specific securities and, if such recommendations are accepted by the client, the adviser is responsible for arranging or effecting the purchase or sale.

[18] An adviser may currently (but is not required to) exclude these items from calculation of assets under management.

[19] The Dodd-Frank Act creates a new Section 202(a)(29) of the Advisers Act that defines a private fund as an issuer that would be an investment company, as defined in Section 3 of the 1940 Act, but for Section 3(c)(1) or 3(c)(7) of the 1940 Act.

[20] The SEC acknowledges that not all private funds use fair value methodologies, which may be more difficult to apply to certain types of assets; however, the SEC believes that fair value reporting will result in more consistent asset calculations where market value is not available.

[21] This could occur because the adviser has its principal place of business in a state that does not require registration (which currently is only Wyoming), or because the adviser could rely on an exemption from registration with the state securities authority under applicable state law. Failure by an adviser to register with a state in contravention of an applicable state statute does not allow an adviser to register with the SEC.

[22] Not all states securities authorities conduct compliance examinations of advisers registered with such authorities. The SEC staff has noted that New York and Minnesota have indicated they will not conduct inspections; therefore, advisers in those states (as well as Wyoming, which does not register advisers) are not subject to the $110 million threshold (but will remain subject to the current $25 million AUM requirement for registration with the SEC).

B. Who Must Register With a State or States? An adviser that is not registered with the SEC will generally need to register with one or more states. Registration requirements for the states vary and may change in coming months and years, but an adviser is generally required to register with states in which it has a place of business[23] and/or in which it has five or more clients. An examination of state registration obligations must be made on a case by case basis, depending upon the law of the various applicable states and the nature of an adviser's operations.

C. What Exemptions May be Available? After the Dodd-Frank Act is effective, there are very few viable exemptions from registration that are available for real estate advisers. Further, an exemption from one regulatory framework (either state or federal) nevertheless requires that an adviser determine if it is subject to registration under the other framework. For instance, an adviser that qualifies for an exemption from SEC registration under the private adviser exemption (discussed below) must then determine if it is exempt from state registration.

1. *Federal Exemption*. An investment adviser that is otherwise required to register under the Advisers Act is not required to register if it satisfies an exemption. As noted above, the Dodd-Frank Act repeals the most widely used exemption, the private adviser exemption. It also, however, adds new exemptions from registration under the Advisers Act.

The most relevant of these new exemptions in this context is the private fund adviser exemption. This exemption is available to an adviser that (1) advises only qualifying private funds,[24] and (2) has aggregate assets under management in the United States of less than $150 million. Under the SEC's rules implementing this exemption, for a U.S. investment adviser, this means that all of the adviser's clients must be qualifying private funds and the aggregate AUM of such funds must not exceed $150 million.[25] For these purposes, AUM would be calculated annually using the same principles set forth above in the context of the $110 million AUM requirement. An adviser relying on this exemption must report its AUM to the SEC on the limited report described below within 90 days of the end of its fiscal year. If a private fund adviser exceeds $150 million in AUM for a year, the adviser would be required to register

[23] Advisers Act Rule 222-1 defines a "place of business" to mean (1) an office at which the investment adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; and (2) any other location that is held out to the general public as a location at which the investment adviser provides investment advisory services, solicits, meets with, or otherwise communicates with clients.

[24] "Qualifying private funds" for purposes of this exemption is a broader term than "private funds" under the Advisers Act, a definition added by the Dodd-Frank Act. "Qualifying private funds" is defined in the proposing release relating to this exemption to mean any entity that is not registered as an investment company pursuant to Section 8 of the 1940 Act, while "private fund" is defined by reference to two specific exemptions from registration commonly used by hedge, venture and private equity funds. As a result, "qualifying private fund" would include a fund that operates without registration as an investment company pursuant to Section 3(c)(5)(C) of the 1940 Act (the section specifically exempting certain funds making real estate and real estate related investments from 1940 Act registration), and the adviser of that fund would be able to rely on the private fund adviser exemption if it has total assets under management of less than $150 million. *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers*, Investment Advisers Act Release No. 3222 (June 22, 2011).

[25] The exemption applies differently in the context of an adviser with its principal place of business outside the United States; such advisers are able to have non-private fund clients outside the United States so long as such clients are not managed from a place of business in the United States, and such advisers are only required to count assets managed from a place of business in the United States toward the $150 million limit. *Id*.

within 90 days of making the required filing. This up to 180-day transition period would only be available to a private fund adviser that was in compliance with applicable reporting requirements described below.

Although private fund advisers are exempt from registration and the vast bulk of regulation under the Advisers Act, private fund advisers are subject to certain limited reporting requirements. A private fund adviser is required to provide certain limited information about itself, its control persons, its operations, its disciplinary and legal history, and any private funds it manages. These reports must be updated periodically and amended as certain information changes. Information reported by a private fund adviser is publicly available through the Investment Adviser Registration Depository (or "IARD") system, which investment advisers use to register as such.

In addition to the reporting requirements discussed above, private fund advisers would also be subject to inspection by SEC staff. Depending upon the motivation for the inspection, SEC inspections can be relatively brief and issue-specific or extremely lengthy and grueling ordeals, lasting weeks or even months. Even in the best of cases, however, preparing for an SEC inspection requires a significant amount of time and attention from an adviser's personnel and can significantly disrupt normal operations.

2. *State Exemptions.* It is unclear how the states will revise their exemptions from registration in response to the Dodd-Frank Act. Many states appear to be waiting for the SEC to adopt implementing rules and regulations regarding the exemptions created by the Dodd-Frank Act (or which the Dodd-Frank Act directed the SEC to create by rule).

NASAA, an association composed of 67 state, provincial, and territorial securities administrators in the 50 U.S. states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada and Mexico, has proposed a new exemption that would, in part, correlate to the private fund adviser exemption. This proposed exemption would, however, only apply to funds relying on Section 3(c)(7) of the 1940 Act in operating without registration as investment companies (which requires that all investors be "qualified purchasers" as defined in the 1940 Act). This limitation to Section 3(c)(7) funds limits the utility of the proposed NASAA exemption. In addition, individual states are free to adopt, modify or reject model provisions published by NASAA.

IV. What are the Main Requirements of Investment Adviser Regulation?

A. Federal Registration. The Advisers Act imposes a number of disclosure and substantive obligations on registered advisers. Below, we first discuss disclosure requirements (primarily Form ADV), and then describe some of the substantive requirements of Advisers Act regulation.

1. *Disclosure*. Form ADV is the primary disclosure document that investment advisers must prepare and maintain. Form ADV is divided into four parts:

- Part 1A is a "check-the-box" document completed and filed and updated through the IARD system that elicits business information about the adviser and its control persons. The SEC has recently adopted a revised version of Form ADV Part 1A.[26] The Part 1A must be updated annually within 90 days of an adviser's fiscal year end, and when certain material changes occur.

[26] *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Advisers Act Release No. 3221 (June 22, 2011).

- Part 1B is a section required by state securities authorities for state-registered advisers that need not be completed by advisers registering under the Advisers Act.

- Part 2A, also referred to as an adviser's "brochure," is a narrative description of the adviser's business, fees, investment strategies, types of clients, conflicts of interest, relationship with affiliates and other financial industry firms, disciplinary history and key risk factors. The Part 2A is also filed through the IARD system. The Part 2A must be updated annually within 90 days of an adviser's fiscal year end, and when certain material changes occur. The Part 2A must be provided to new and prospective clients at or before the clients enter into an advisory agreement with the adviser.

- Part 2B, also referred to as an adviser's "brochure supplement," is a narrative document that provides information about supervised persons of an adviser who formulate investment advice for clients. A brochure supplements generally is required to be promptly updated if any information in the brochure supplement becomes materially inaccurate and must be delivered to clients along with the initial delivery of the Brochure, but is not required to be filed with the SEC. An adviser must begin providing Part 2B to new and prospective clients on July 31, 2011, and must provide the Part 2B to existing clients by September 30, 2011, unless further postponed by the SEC.

In addition to the specific disclosure required on Form ADV, an investment adviser is a fiduciary with respect to its clients, and, as a result, must disclose any material conflicts of interests it faces in providing advisory services to its clients. The scope of this disclosure requirement will depend upon the nature and structure of an adviser's relationships with its clients, service providers, affiliates and third parties.

2. *Compliance Program*. A registered investment adviser is required to appoint a Chief Compliance Officer that is responsible for the adviser's compliance program. An investment adviser is required to adopt, implement and maintain a compliance program based on (1) written compliance policies and procedures[27] reasonably designed to prevent violation by the adviser and its supervised

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[27] Written compliance policies and procedures are required by Advisers Act Rule 206(4)-7. In the adopting release for the rule, the SEC stated that, at a minimum, it would expect such a compliance program to include policies regarding: (1) portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with guidelines established by clients, disclosures by the adviser, and applicable regulatory restrictions, (2) trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregate trades among clients, (3) proprietary trading of the adviser and personal trading activities of supervised persons, (4) the accuracy of disclosures made to investors, clients and regulators, including account statements and advertisements, (5) safeguarding of client assets from conversion or inappropriate use by advisory personnel, (6) the accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction, (7) processes to value client holdings and assess fees based on those valuations, (8) safeguards for the privacy protection of client records and information, and (9) business continuity plans. *See Compliance Programs of Investment Companies and Investment Advisers*, Investment Advisers Act Release No. 2204 (December 17, 2003).

persons, and (2) a code of ethics[28] that (a) requires reporting of certain adviser personnel's securities holdings and transactions, (b) requires that the Chief Compliance Officer or its designee pre-approve investments in initial public offerings and private offerings, (c) generally provides policies on giving and accepting gifts and entertainment, and (d) includes policies intended to address material non-public information and to prevent its misuse.

The Chief Compliance Officer is ultimately responsible for administering the compliance program and conducting the required annual reviews.[29]

3. *Recordkeeping*. A registered investment adviser is required to maintain and preserve books and records and make them available to the SEC for inspection. A registered investment adviser is required to keep a broad range of records regarding the business of the adviser and its operations, including communications with clients such as emails and other correspondence.[30] These records generally must be kept in an orderly manner and preserved for a period of not less than five years in an easily accessible place from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the adviser.[31]

4. *Custody of Client Funds*. Registered investment advisers that maintain custody over client funds or securities, as defined in Rule 206(4)-2 under the Advisers Act, have certain obligations with regard to safeguarding those assets. Specifically, an adviser has custody of client assets, and therefore must comply with the rule, when it holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them. An adviser is deemed to have custody of client assets if it has the ability to deduct advisory fees (or other expenses) directly from a client's account or is the general partner or managing member of a fund.

Generally, if an adviser has custody, it must:

- Maintain assets with a qualified custodian (normally a bank or broker-dealer)[32] in a separate account for each client or accounts that contain only the adviser's clients' funds and securities, under the adviser's name as agent or trustee for the clients,

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28 The code of ethics is required by Advisers Act Rule 204A-1.

29 Advisers Act Rule 206(4)-7 requires that an adviser conduct an annual review, no less frequently than annually, of the adequacy of the adviser's compliance policies and procedures and the effectiveness of their implementation.

30 A full list of the categories of required records can be found in Rule 204-2 under the Advisers Act.

31 Certain special rules apply with respect to records containing performance marketing materials (which must be maintained for five years after the date of last use) and certain corporate records (which must be maintained for three years after termination of the adviser.

32 Subject to certain conditions, certain investments need not be maintained with the qualified custodian, so long as the investments are (a) acquired from the issuer in a transaction or chain of transactions not involving any public offering; (b) uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and (c) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer. *See* Advisers Act Rule 206-4(b)(2).

- have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of the adviser's clients for which it maintains funds or securities, and

- undergo an annual surprise verification audit of custodied funds by an independent public accountant that is registered with and inspected by the Public Company Accounting Oversight Board (the "PCAOB").

An adviser is not required to comply with the foregoing with respect to a pooled investment fund if that fund is audited annually by an independent public accountant that is registered and inspected by the PCAOB, and audited financial statements are delivered to investors within 120 days of the end of the fund's fiscal year.[33]

5. *Pay-to-Play Restrictions*. Government plans and government-related entities are increasingly investing in real estate as an alternative asset class. As a result, real estate advisers may be particularly concerned with the recently adopted SEC rule governing pay-to-play scenarios that impose significant burdens on advisers that solicit and manage the assets of such clients (including registered advisers and advisers that are unregistered in reliance on the private fund adviser exemption).

Advisers Act Rule 206(4)-5 (the "Pay-to-Play Rule") contains three fundamental prohibitions.[34] First, it prohibits an adviser from providing investment advisory services for compensation to a government entity[35] for two years after a contribution[36] to an official[37] of the government entity is made by the adviser or the adviser's covered associates.[38] These restrictions can apply to the activities of covered associates for the two years before they became covered associates of the adviser.[39]

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33 This period is increased to 180 days for funds that invest in lower level funds (fund-of-funds) and to 240 days for funds that invest in fund-of-funds (fund-of-funds-of-funds).

34 Rule 206(4)-5 applies to registered advisers and advisers exempt from registration under the private adviser exemption. Rule 206(4)-5(a).

35 A "government entity" means any state or political subdivision of a state, including (i) any agency, authority, or instrumentality of the state or political subdivision, (ii) a pool of assets sponsored or established by the state or political subdivision or agency, (iii) a plan or program of a government entity, and (iv) officers, agents or employees of the state or political subdivision or agency.

36 "Contribution" means any gift, subscription, loan, advance or deposit of money or anything of value. A charitable donation made to an organization that is exempt under Section 501(c)(3) of the Internal Revenue Code of 1986 would not generally be considered a contribution (even if solicited by a government official) and donation of time by an individual would not be considered a contribution if the adviser did not solicit the individual's efforts and adviser's resources (such as office space and telephones) were not used.

37 An "official" is any person (including any election committee of the person and any political action committee) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a government entity, if the office (i) is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity, or (ii) has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity. "Influence" should be construed broadly.

38 A "covered associate" is defined in the Rule as: (i) any general partner, managing member or executive officer, or other individual with a similar status or function; (ii) any employee who solicits a government entity for

There is an exception available from the prohibition above for contributions from covered associates who are natural persons who make contributions to any official that do not in the aggregate exceed $350 per election if the covered associate was entitled to vote for the official at the time or $150 per election if the covered associate was not entitled to vote for the official at the time (the "*De Minimis* Exception").[40]

Second, the Rule prohibits the adviser or its covered associates from providing or agreeing to provide payment to any person to solicit government entities for advisory services on behalf of the adviser, unless the solicitor is (i) a "regulated person" that itself is subject to regulations restricting political contributions, or (ii) an executive officer, general partner, managing member, or employee of the adviser. A "regulated person" includes a broker-dealer that is registered with the SEC and the Financial Industry Regulatory Authority, Inc. ("FINRA"), as long as FINRA adopts its own suitable regulations addressing "pay-to-play" practices (which FINRA has announced that it intends to do). To provide FINRA time to propose, and the SEC to adopt, such regulations, this prohibition is not effective until September 13, 2011.

Finally, the Rule prohibits the adviser and its covered associates from coordinating or soliciting any person or political action committee ("PAC") to make (i) any contribution to an official of a government entity to which the adviser is providing or seeking to provide advisory services, or (ii) any payment to any state or local political party where the adviser is seeking to provide advisory services to a government entity. This prohibition is intended to prevent advisers from circumventing the Rule by making indirect contributions through political organizations or "bundling" smaller employee contributions that are permitted under the Rule.

Clearly, the Rule imposes significant monitoring obligations on the political contributions of personnel as a prophylactic measure to ensure an adviser is not precluded from later accepting a government-related entity as a client.

6. *Limits on Performance Compensation*. A registered adviser may only accept performance-based compensation, such as a performance fee or an incentive allocation, with respect to a client if the client (or, in the case of a fund, if each investor that participates in making such a fee payment or allocation) is a "qualified client" or if the performance compensation is structured as a "fulcrum fee."[41] A "qualified client" is (a) a natural person who or a company that immediately after entering into the contract (or making the fund investment) has at least $750,000 under the management of the investment adviser or (b) a natural person who or a company that the investment adviser reasonably believes, immediately prior to entering into the contract, either: (i) has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1,500,000 at the time the contract is entered

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the adviser and any person who supervises, directly or indirectly, such employee; and (iii) any political action committee controlled by the adviser or by any person described in (i) or (ii) above.

39 The look-back period for covered associates who are not involved in soliciting clients or investors, however, is six months instead of two years.

40 For purposes of this exception, primary and general elections are considered separately.

41 A fulcrum fee means a fee averaged over a specified time period that adjusts proportionately to the performance of a client's or fund's account in relation to the performance of a securities index, benchmark or other measure of performance.

into (or the fund investment made);[42] or (ii) is a qualified purchaser as defined in 1940 Act at the time the contract is entered into (or the fund investment made). Under the Dodd-Frank Act, the SEC must adjust these dollar amounts for inflation no later than July 21, 2011, and every five years thereafter.[43]

Many real estate advisers receive a carried interest from real estate related investments, making the performance compensation provisions particularly important to real estate advisers.

7. *Provisions in Advisory Contracts.* A registered investment adviser may not enter into an advisory contract with a client unless the contract provides that it cannot be assigned by the adviser without the client's consent. This raises particularly difficult issues when an adviser seeks to sell its business or to accept large new investors in the management entity.

8. *Marketing Restrictions and Requirements*. The Advisers Act imposes significant limitations and restrictions on the content and types of advertisements a registered adviser may employ. It defines "advertisement" broadly to include any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, when meant to solicit new clients or investors or maintain existing clients or investors, which offers: (1) any analysis, report or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell; (2) any graph, chart, formula or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell; or (3) any other investment advisory service with regard to securities. As a result, the advertising rules and regulations capture a significant amount of communications that would not be traditionally considered "marketing materials." These rules and requirements are extremely complicated and detailed, and registered advisers generally require all materials that fall within the scope of the term "advertisement" to be reviewed by the Chief Compliance Officer and, at times, outside counsel prior to use.

B. <u>State Registration</u>. Requirements applicable to advisers registered under state securities laws vary widely. Some are quite similar to the federal requirements and some impose additional or varying requirements.

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We would be happy to discuss any feature of this memorandum or analysis, as well as any other matters, in greater depth.

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42 Pursuant to the Dodd-Frank Act's requirements, the SEC issued a notice of its intent to issue an order on or prior to July 21, 2011, raising the dollar figures used in determining qualified client status from $750,000 and $1.5 million to $1 million and $2 million, respectively. The SEC is also proposing a revision to Rule 205-3 that would require the dollar figures used in assessing qualified client status to be updated to account for inflation every five years. *See Investment Adviser Performance Compensation*, Proposed Rule and Notice of Intent to Issue Order, Investment Advisers Act Release No. 3198 (May 10, 2011).

43 The Dodd Frank Act requires this adjustment in an amendment to Section 205(e) of the Advisers Act.