Dallas Bar Association Securities Section

Real Estate as a Security: From the Howey Test to the Advisers Act

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AGENDA

- When Real Estate Becomes a Security (Howey Test Analysis)
- Investment Adviser Act Requirements
- Investment Company Act Issues and Exemptions
- Private Placement Compliance
- Bad Actor Issues
- FINRA Compliance Requirements
- SEC Enforcement Trends and Priorities
- Best Practices

Federal Securities Laws Framework

A Diversity of Rules and Regulations

Securities Act of 1933

- Registration and exemptions for securities offerings

Securities Exchange Act of 1934

- Ongoing reporting and market regulation

Investment Advisers Act of 1940

- Regulation of investment advice

Investment Company Act of 1940

- Regulation of pooled investment vehicles

State Blue Sky Laws

- State-specific regulation

Do I Need to Worry?

Real estate developers often inadvertently create securities through common business practices

- Any pooling of investor funds may create securities
- Severe penalties for non-compliance (SEC enforcement actions, rescission rights)
- Joint ventures, syndications, and TICs often involve securities
- Even 'traditional' real estate deals can trigger securities laws
- Recent SEC focus on real estate sector compliance
- The Howey Test still rules...

The Howey Test

When Real Estate Becomes a Security

- Supreme Court framework
  - SEC v. W.J. Howey Co. (1946)
- The Howey Test determines if a real estate transaction is a security.
- It asks:
  - (1) if there in an investment of money;
  - (2) in a common enterprise;
  - (3) with an expectation of profits; and
  - (4) that is derived from others' efforts.
- Syndications, TIC deals, and passive real estate investments often meet Howey's four criteria.
- Basic questions to consider:
  - Is your client investing in dirt...or a contract to acquire dirt?
  - Is that contract specific to the real property, or is it a derivative of that real property?
  - Is this a one-off joint venture, or is one party purely passive and the other fully relied upon for creating value?

Element No. 1

Investment of Money

- Cash contributions clearly qualify
- In-kind contributions (property, services) may qualify
- Promissory notes and deferred payment arrangements
- Analysis focuses on economic reality, not form
- Broad interpretations that can include items such as in-kind contributions.

Element No. 2

Common Enterprise

Commonality:

- Horizontal commonality: pooling of investor funds
- Vertical commonality: success tied to promoter's efforts
- Broad vertical commonality (rejected by some circuits)

Real estate syndications typically satisfy a commonality element

Circuit courts split on types of commonality

- FYI: Most real estate deals satisfy horizontal commonality.

Element No. 3

Expectation of Profits

Profits:

- Profits include capital appreciation, not just cash flow
- Rental income projections may constitute profit expectation
- Marketing materials emphasizing returns create expectations
- Tax benefits alone typically insufficient
- Broad interpretation of profits and marketing materials are critical evidence.

Examples:

- Turnkey Real Estate Investments: Courts have found that purchasing real estate with rental management provided by a promoter—where investors rely on others for returns—meets the profits prong
- TIC Structures: Where day-to-day operations and income distributions are controlled by a professional manager, passive TIC investors are deemed to expect profits from the efforts of others, satisfying Howey

Element No. 4

Efforts of Others

Effort is:

- Critical element for real estate securities determinations
- Active investor participation may defeat security classification
- Professional management arrangements support security finding
- Limited voting rights and control indicate passive investment

This is by far the most contested element in real estate context, and key to structuring whether classification as a security is eschewed or embraced by your client.

Element No. 4

Efforts of Others

Howey:

- Profits came from the promoter's cultivation, harvest, and sale of crops, not from any action by land investors themselves—investors played no active role

Syndications:

- Investors contribute capital, while all development decisions, leasing, property management, and resale timing are controlled by the sponsor or manager, making investors' profits dependent on that party's expertise and actions.

Real Estate Scenarios

Securities vs. Non-Securities

NON-SECURITIES:

- Direct property ownership with active management
- True partnerships with active participation

SECURITIES:

- Syndicated offerings with passive investors
- TICs with professional management agreements
- Crowdfunded real estate investments

Real Estate Scenarios

Tenancy in Common (TIC)

Guidance:

- Rev. Proc. 2002-22: IRS guidelines for TIC 1031 exchanges
- Mathews v. Cassidy Turley Maryland (2013): TIC held to be security

Key factors:

- Mandatory management contracts, limited investor control
- Professional management and marketing to passive investors
- State law variations in TIC security classification

Real Estate Scenarios

Joint Ventures and Syndications

JV Common Denominators:

- JV interests generally constitute securities under Howey
- Limited partner interests in limited partnerships are securities
- LLC membership interests may be securities depending on structure
- Operating agreements cannot override federal securities law analysis

Form not Substance:

- Entity form does not determine securities status - economic substance controls
- Just how involved are all members of the joint venture? Is there a common promoter? Does the promoter manage all aspects of the JV?

Real Estate Scenarios

Recent Howey Developments

SEC and Howey:

- 2025 trends involve continued reliance on Howey framework
- SEC focus on “efforts of others” prong in real estate context
- Digital assets cases influencing real estate analysis
- Circuit court splits on commonality requirements

State Variations

- Risk capital test in some jurisdictions
- NY and Real Estate Syndications

Evolving:

- Howey is 80-years old yet still applied in a modern context
- All structures must be viewed against this test and its broad interpretation

Investment Adviser Act

When Registration is Required

Investment Adviser

- Definition: Providing investment advice for compensation
- Real estate fund sponsors often qualify as investment advisers

AUM Thresholds

- $100M+ for SEC registration
- State vs. Federal thresholds

Caution Advised

- Many real estate professionals inadvertently become investment advisers.

Real Estate Advisers

Registration Analysis

Fund Management in Focus

- Managing "real estate" funds generally involves providing investment advice
- Asset selection, timing, and strategy decisions
- Compensation through management fees and carried interest
- *Exclusions*: solely incidental advice without separate compensation

Recent Trend:

- Real estate advisers seeking de-registration
- How is this effected? When is it appropriate?

Real Estate Advisers

AUM Calculation

AUM Test:

- Include all discretionary and non-discretionary advisory assets
- Real estate valued at “fair market value”
- **Exclude** non-advisory assets and activities
- Special considerations for real estate-specific assets
- Valuation and calculation issues specific to illiquid real estate assets

Real Estate Advisers

Registration Requirements

Filing Requirements:

- Form ADV Parts 1 and 2 (brochure) filings
- Annual updates and material amendments
- Code of ethics and compliance program required
- Books and records maintenance (Rule 204-2)
- Custody rule compliance (Rule 206(4)-2)

Ongoing Oversight:

- The rules are strict but fair
- Most real estate sponsors inadvertently comply with many of the regulatory requirements and simply need a framework to ensure compliance is maintained

Real Estate Advisers

Exemptions from Registration

Intrastate Advisers

- All clients in one state

Private Fund Advisers

- Not an absolutely exemption and, instead, more limited registration requirements

Venture Capital Fund Advisers

- Securities but activities qualify for VC treatment

Foreign Private Advisers

- No US Clients or presence

Family Offices

- True family offices with no non-family capital or stakeholders

SEC and Real Estate Advisers

2025 Priorities and Enforcement

Areas of Emphasis:

- Fiduciary duty compliance (care and loyalty)
- Commercial real estate exposure and valuation
- AI and technology integration in advisory operations
- Conflicts of interest and fee transparency
- Cybersecurity and data protection

Enforcement:

- Increased focus on fee transparency and calculations
- Valuation issues for illiquid real estate assets
- Marketing rule compliance (Rule 206(4)-1)
- Custody violations in real estate context
- Conflicts in adviser-led fund restructurings

Investment Company Act

Key Concepts

- Definition: entity primarily engaged in investing in securities
- Real estate funds may qualify as investment companies
- Registration requirement unless exemption available
- Extensive regulatory burden for registered investment companies
- Common exemptions: 3(c)(1), 3(c)(5)(C), 3(c)(7)

Investment Company Act can apply to real estate funds - exemptions critical.

Investment Company Act

Section 3(c)(1) Exemption

Applies to:

- An entity with greater than 100 beneficial owners (250 for VC funds)
- No restrictions on investor type or asset type
- Look-through rules for fund-of-funds
- This is the common exemption for small private funds

Disadvantages

- Investor count limitations

Investment Company Act

Section 3(c)(7) Exemption

Applies to:

- Vehicles where all investors are “qualified purchasers”
- QP definition: $5M+ investments (individuals) or $25M+ (entities)

Notes:

- No limit on number of investors
- Higher investor sophistication threshold than accredited investor
- Suitable for larger funds with wealthy investors
- Higher wealth threshold exemption allowing unlimited investors

Investment Company Act

Section 3(c)(5)(C) Exemption - Focus

Unique to Real Estate:

- Specifically designed for real estate investments
- Asset composition test: **55% in qualifying real estate interests**
- 25% in real estate-related interests
- 20% maximum in non-real estate assets
- No investor limitations or registration requirements

What Qualifies?

- Fee interests in real estate
- Mortgage loans secured by real estate
- Notes secured by mortgage pools
- Mezzanine loans (Tier 1) to special purpose entities
- Must represent 'actual interest' in real estate

Investment Company Act

Section 3(c)(5)(C)
Real Estate-Related Interests

Real-Estate Related:

- Assets related to real estate but not qualifying interests
- Government agency mortgage-backed securities
- Real estate development loans
- Equipment and fixtures affixed to real property
- **Cannot exceed 25% of total portfolio**

Real Estate Securities

Key Federal Rules and Exemptions

Regulation D: Safe Harbor Exemptions

- Rule 504: Up to $10M in 12 months
- Rule 506(b): Unlimited amount, no general solicitation
- Rule 506(c): Unlimited amount, general solicitation allowed
- Federal preemption of state registration (Rule 506)
- Form D filing requirements within 15 days

Rule 506(b): Traditional Private Placement

- Up to 35 non-accredited investors allowed
- Unlimited accredited investors
- No general solicitation or advertising
- Pre-existing substantive relationship required
- Sophisticated investor standard for non-accredited

Rule 506(c): General Solicitation Allowed

- All purchasers must be accredited investors
- Reasonable steps to verify accredited status required
- General solicitation and advertising permitted
- Higher compliance burden for verification
- Popular for real estate crowdfunding platforms

Real Estate Securities

Key Federal Rules and Exemptions

General Solicitation?

- Newspaper ads, websites, seminars clearly constitute general solicitation
- Pre-existing substantive relationship exception
- Rule 241: Testing-the-waters communications
- Social media and digital marketing considerations
- Safe harbor for generic solicitation of interest
- **Critical distinction affecting choice between 506(b) and 506(c)**

Real Estate Securities

Key Federal Rules and Exemptions

Accredited Investor Verification

- 2020 amendments expanded accredited investor definition
- Income test: $200K individual/$300K joint (last 2 years)
- Net worth test: $1M excluding primary residence
- Professional certifications and knowledge-based qualifications beyond wealth.

Private Placement Memorandum (PPM) Requirements

- Material information disclosure requirements
- Risk factors specific to real estate investments
- Financial statements (audited for 506(b) non-accredited)
- Management discussion and analysis
- Anti-fraud liability under Rule 10b-5

Real Estate Securities

Key Federal Rules and Exemptions

Bad Actor Disqualification: Rule 506(d)

- Effective September 23, 2013
- Disqualifies offerings with 'covered persons' having disqualifying events
- Applies to both Rule 506(b) and 506(c) offerings
- Disclosure required for pre-2013 events
- Due diligence obligations for issuers
- **Important disqualification provisions affecting Rule 506 availability**

Real Estate Securities

Key Federal Rules and Exemptions

Covered Persons Definition

- Issuer and predecessors/affiliated issuers
- Directors, executive officers, general partners
- 20%+ beneficial owners
- Investment managers and their controlling persons
- Promoters connected with issuer
- Compensated solicitors and their controlling persons

Disqualifying Events

- Criminal convictions (securities, fraud, underwriter-related)
- SEC, FINRA, state regulatory orders
- Court injunctions and restraining orders
- Investment adviser or broker-dealer bars
- Insurance and banking regulatory actions

Bad Actor Compliance Procedures

- Questionnaires for all covered persons
- Ongoing monitoring during offering period
- Background checks and public record searches
- Waiver requests to SEC for unavoidable disqualifications
- Documentation of reasonable care standard

Real Estate Securities

Key FINRA Rules

FINRA Rules for Private Placements

- Rule 5122: Member private offerings
- Rule 5123: Private placements filing requirements
- Due diligence and suitability obligations
- Regulation Best Interest compliance
- Recent amendments expanding exemptions
- FINRA rules apply when broker-dealers participate in offerings.

FINRA Filing Requirements

- Form filing within 15 days of first sale
- PPMs, term sheets, and offering documents
- Retail communications promoting placements
- Exemptions for certain institutional investors

2024 amendments expanding accredited investor exemptions

Real Estate Securities

Key FINRA Rules

FINRA Real Estate Compliance Issues

- Unlisted REIT and/or seed capital investments
- Outside business activities for registered persons
- Conflict of interest rules (Rule 5121)
- Underwriting compensation issues
- Private placement suitability standards

Recent FINRA Developments (2024-2025)

- Proposed amendments to outside business activity rules
- Enhanced capital formation exemptions
- Updated qualified institutional buyer standards
- Focus on alternative investments and illiquid asset

Best Practices

Enforcement Actions as a Guide

Real Estate Specific Enforcement Focus

- Illiquid asset valuation methods and conflicts
- Interest rate sensitivity and changing market conditions
- Adviser-led fund restructurings and valuations
- Marketing rule compliance for real estate funds
- Fee transparency and calculation accuracy

Recent Real Estate Enforcement Actions

- April 2025: $284M municipal bond fraud (Arizona)
- Increased focus on offering fraud in real estate
- Receivership actions for misappropriation
- Emphasis on accurate revenue projections
- Sanctions for false documentation and contracts

Best Practices

Create a Checklist

Compliance Best Practices Checklist

- Conduct Howey analysis before structuring transactions
- Implement robust bad actor screening procedures
- Maintain accurate investor records and accreditation verification
- Ensure PPM disclosures are complete and current
- File Form D timely and accurately

Documentation and Record-Keeping

- Maintain investor accreditation documentation
- Document pre-existing relationships for 506(b) offerings
- Keep bad actor questionnaires and background checks
- Preserve all marketing materials and communications
- Implement document retention policies

Ongoing Compliance Monitoring

- Regular review of asset composition (3(c)(5)(C) funds)
- Monitor for material changes requiring Form D amendments
- Update PPMs for material developments
- Annual compliance reviews and training

- **Program Opportunities**
  - CLEs and Speakers
  - Targeted Industry Events
  - Marketing and Development Opportunities
- **Section Engagement**
  - All Members Encouraged to Participate
  - Request a Panel Slot or Speaking Opportunity
- **Industry Outreach**
  - Later this Year SEC/FINRA Regulators Will Participate
    - What do you Want to Hear from Them?
  - Later this Year Principals of RIAs and BDs Will Participate
    - What do you want to Hear from Them?

THANK YOU

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