Real Estate Pledge Funds:
An Alternative in the Alternative Space

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THE CHALLENGING FUND-RAISING ENVIRONMENT of the past few years for the alternative asset market has drawn increasing attention to fund-raising alternatives, including a revival of interest in "pledge fund" structures.[1] Pledge funds, once more popular as precursors to true blind pool funds, fell out of favor during the frothy fund-raising period of the mid-2000s. However, as fund sponsors have seen the fund-raising market tighten and investors increase their interest in "direct" investments, a market has begun to develop for pledge funds. These fund structures can present an attractive midpoint between the direct investment model and a fully committed blind pool, enabling sponsors to have some amount of certainty in funding their deals and allowing investors to retain discretion over their investment decisions by being able to opt in or opt out on a deal-by-deal basis. Similarly, investors that, for a variety of reasons, have moved away from the blind pool in favor of a more-directed strategy can find the pledge model very attractive. As a result, the pledge fund structure may be of significant benefit to first-time sponsors or other investment managers seeking an alternative to the blind pool or separately managed account model.

The pledge fund model may also, at first blush, appeal to fund sponsors that are looking to avoid registering as an investment adviser under the Investment Advisers Act of 1940, as amended, on the theory that because the pledge fund investors retain ultimate investment discretion, the sponsor is not in fact dispensing investment advice as an investment adviser. However, as discussed later, forfeiting investor discretion alone will not remove the sponsor from the requirement to register under the Advisers Act. In fact, owing to the way in which pledge funds are often structured—as contractual arrangements instead of legal entities—sponsors of pledge funds may in some cases be more likely to register than sponsors of committed funds. Nonetheless, sponsors of pledge funds that invest exclusively in hard real estate assets may very well be able to avoid registration.

This article describes the basic features of pledge funds and addresses where the pledge fund fits in the current regulatory landscape since the Dodd-Frank Wall Street Reform and Consumer Protection Act.

1. "Fewer Blank Checks in Private Equity's Pocket," *Wall Street Journal*, March 26, 2012.

Background and Structure

Pledge funds are often contractual arrangements taking the form of individual "investment" or "participation" agreements between the sponsor and each investor. Pledge funds can also be structured as sponsor-managed limited partnerships or LLCs, with the participating investors admitted as limited partners or members. Whether a pledge fund is structured as a contractual arrangement or as a partnership or another vehicle, a new vehicle would typically be formed to facilitate each investment, admitting only those investors that have opted in to make the investment. Investors that opted out of the investment are therefore shielded from any exposure resulting from an investment they do not make.

Terms and Conditions

The terms and conditions of pledge funds tend to vary more than those of traditional blind pool funds. However, as for traditional funds, the negotiations often revolve around a limited number of fundamental provisions.

Management Fees

In a typical blind pool investment fund, the sponsor is paid a management fee calculated on a formula that ties to the activities of the fund during certain specified periods. During the fund's "investment period," when the sponsor is engaged in sourcing deals and actively investing the fund's committed capital, the management fee is typically equal to a percentage of the aggregate amount of that committed capital. After the end of the investment period, the sponsor is typically restricted from making new investments, and the management fee is calculated on the amount of capital actually invested in the portfolio of assets.

In the case of pledge funds, similar considerations apply. On the one hand, sponsors must be compensated—and properly motivated—to effectively source, conduct due diligence on, and execute appropriate investment opportunities. On the other hand, participants are wary of paying a fee up-front, especially given that they have no assurance that the sponsor's efforts will result in even a single investment. The resolution is often some form of management fee calculated on the "pledged" capital—though often at a lower rate than would be the case in a "committed" capital fund—and a high-

er invested capital–based fee, charged if and when an investor opts to participate in a given investment. Other fee options include a fixed "participation fee," payable at regular intervals, that might be offset against future fees due on invested capital, or a pre-agreed-upon expense reimbursement schedule. A key difference between a blind pool fund and a pledge fund may be found in the treatment of broken deal expenses, which are generally passed on to the investors in a blind pool fund but not in a pledge fund (because there is no assurance that any participant would have opted in to the transaction).

Carried Interest

Pledge fund terms show a greater variation than blind pool funds with respect to the calculation of the carried interest earned by the sponsor on investor profits. A core premise of blind pool funds is the "netting" of deals, which is intended to ensure that a sponsor does not reap a windfall from successful deals while leaving the investors with a potential net loss on their commitments resulting from poorly performing ones. In the pledge fund context, however, while some funds do provide for such "cross-netting," many calculate the sponsor's carried interest only on an investment-by-investment basis with no clawback or other "true-up" mechanism. This reflects the premise that if investors are being given the freedom to underwrite each investment separately, each investment should also stand alone on an economic basis, as a separate financial arrangement.

Pledge funds also differ significantly from blind pool funds in that a pledge fund does not typically have a differentiated investment period followed by a harvest period. Therefore, a pledge fund sponsor will often be able to make investments throughout the term of the investment contract and may have more freedom to provide for longer hold periods on a deal-by-deal basis. In turn, pledge funds can often provide "patient" capital to sponsors looking for more exit flexibility.

Pledge Fund Operations: Timing and Investment Process

Under a pledge fund's participation agreement, sponsors typically have an obligation to bring all suitable investment opportunities that meet certain predefined parameters to the investors. After the sponsor presents the deal, each investor will decide whether to invest or not. In some pledge fund arrangements, if investors pass on too many potential investments, they may be ineligible to participate in future deals (for example, three strikes and you're out). If a particular investment is underfunded because of a lack of investor participation, the sponsor will often have the right to offer participating investors the option to invest the unallocated amount, or the sponsor might ultimately need the ability to pursue third-party co-investors.

One potential drawback of the pledge fund from a sponsor's perspective is the time that may be needed to solicit investor elections whether to participate in a given investment opportunity and to negotiate the documentation pursuant to which the investment will be made. This can be mitigated by having sponsors and investors agree in advance to a set format for the due diligence materials to be provided as part of the solicitation, by carefully controlling the time frame within which investment elections must be made, and by pre-negotiating a form of investment vehicle agreement (typically, a limited partnership agreement or an LLC agreement) for the single-purpose vehicle to which the electing participants will be admitted as passive investors. Still, even with a streamlined diligence, election, and admission process, pledge funds are best considered for sponsors operating in deal environments in which the deals are sourced on a proprietary basis, rather than an active bidding situation, or where the sponsor can be reasonably assured of longer lead times and diligence. Pledge funds are not an optimal platform from which to provide capital for distressed situations or for stalled deals on the brink of foreclosure.

While pledge funds may thus be at somewhat of a timing disadvantage to committed funds "on the way in" to the transaction, as previously discussed, they often benefit "on the way out," owing to their more relaxed exit horizons.

Structuring Pledge Funds Under the Investment Advisers Act

Although pledge fund investors do not cede investment discretion to the sponsor, the sponsor is not thereby able to avoid registering as an investment adviser under the Advisers Act on the basis that it is the investor—and not the sponsor—that is making the investment and disposition decision. First, while exercising investment discretion on behalf of a client may be *sufficient* to bring a sponsor under investment adviser regulation, it is not *necessary*. The Advisers Act defines an "investment adviser" as "any person who, for compensation, engages in the business of advising others . . . as to the advisability of investing in . . . securities."[2]

That definition is satisfied by the pledge fund sponsor by virtue of agreeing to source and present investment opportunities to the participants for their final decision.[3] Second, the sponsor will in fact exercise investment discretion over the investments once made—deciding how best to manage and ultimately exit the investments. Pledge fund sponsors thus fall squarely within the definition of "investment adviser" by virtue of the advice they provide to, and the compensation they receive from, the pledge fund investors.

Assume that a pledge fund sponsor will not otherwise be able to qualify for any of the statutory exclusions from the "investment adviser" definition set forth in the Advisers Act that apply to, for example, banks, lawyers, teachers, or newspaper publishers.[4] As long as the "soft commitments" to a pledge fund program are at least $100 million,[5] the adviser of a pledge fund has to contend with the same regulatory analysis as the sponsor of a blind pool fund. In other words, the adviser will have to register with the SEC unless there is an applicable exemption under Section 203 of the Advisers Act.

One primary exemption that committed fund sponsors look to is the Private Fund Adviser exemption. Section 408 of Dodd-Frank added a new Section 203(m) to the Advisers Act. Under 203(m), an investment adviser is exempt from registering with the SEC if it advises solely one or more *private funds* and has assets under management in the United States of less than $150 million.

Generally speaking, a "private fund" means an issuer that qualifies for an exclusion from the definition of an "investment company" as defined in Section 3 of the Investment Company Act of 1940, in reliance on section 3(c)(1) or 3(c)(7) of that act.[6] An issuer may rely on 3(c)(1) if its outstanding securities are beneficially owned by not more than 100 persons and if it is not making and does not presently propose to make a public offering of its securities. An issuer may rely on 3(c)(7) if its outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers"

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2. Investment Advisers Act, Section 202(a) (11).
3. Ibid.
4. Ibid.
5. Ibid, Section 203A(b)(1)(A)
6. Investment Advisers Act, Section 202(a) (29).

(e.g., natural persons who own at least $5 million in investments and persons acting for their own accounts or the accounts of other qualified purchasers who in the aggregate own and invest on a discretionary basis at least $25 million) and if it is not making and does not propose to make a public offering of such securities. Many real estate investment funds qualify under either or both of 3(c)(1) or 3(c)(7), and therefore, would generally be exempt from registering as an investment adviser under the "private fund adviser" exemption—provided the fund sponsor acts as a sponsor solely to one or more of these "private funds" whose combined assets under management is less than $150 million.

However, the private fund adviser exemption would in the vast majority of cases not apply to sponsors of real estate pledge funds. Pledge fund platforms are typically structured as contractual arrangements (i.e., the "investment" or "participation" agreement) and not as stand-alone limited partnerships or similar legal entities. Therefore, the clients of the sponsor are the individual pledge fund participants and not any "private fund" to speak of. While it is possible to structure the pledge fund platform through a limited partnership or another similar vehicle—which, if structured to comply with 3(c)(1) or 3(c)(7), might make use of the private fund adviser exemption—the vast majority of pledge funds are structured as contractual arrangements.

For a sponsor looking to raise a fund to make investments in the real estate sector, a key regulatory construct for pledge funds can be very useful and may provide a strong argument for adopting this model. Recall that the Advisers Act defines an "investment adviser" as "any person who, for compensation, engages in the business of advising others … as to the advisability of investing in … securities."[7] If the sole investment mandate of a fund—either a traditional committed fund or a pledge fund—is to invest in actual real estate, then the adviser to the fund is not advising its investors as to investing in securities in the first place. The term "security" is defined expansively in the Advisers Act but does not include core real estate, such as dirt or buildings.[8] A sponsor wishing to take this route, however, must take great care to ensure that its pledge fund investors truly invest in nothing other than actual real estate (and cash equivalents pending investment in actual real estate) and not in short-term bond holdings, mortgages, or other liens on and interests in real estate that may be considered securities.[9] This analysis would apply equally to blind pool real estate funds were it not for the fact that blind pool real estate funds are more likely than pledge funds to invest at least a portion of their commitments in securities—for example, non-controlling interests in real estate joint ventures.

Conclusion

Real estate pledge funds present a distinct alternative to the traditional investment fund model and offer advantages to investors looking for flexibility and discretion, as well as to first-time sponsors or others seeking greater access to capital. Sponsors looking to raise pledge funds are more likely than their traditional committed fund counterparts to have to register as investment advisers under the Advisers Act, absent creative structuring or a firm commitment to invest in nothing other than actual real estate. ■

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7. Investment Advisers Act, Section 202(a) (11).
8. Based on the Supreme Court decision in *SEC v. Howey Co., 328 U.S. 293 (1946),* interests in a joint venture are deemed "securities" if their holder's expectation of profits from the joint venture is dependent on the efforts of a third party. Therefore, were a pledge fund to invest in real estate via a joint venture controlled by a third party, it would likely be deemed to be holding a "security" in the joint venture.
9. Based on the Supreme Court decision in *SEC v. Howey Co., 328 U.S. 293 (1946)*, interests in a joint venture are deemed "securities" if their holder's expectation of profits from the joint venture is dependent on the efforts of a third party. If, on the other hand, the holder of the joint venture interest expects to reap profits based on the holder's own efforts, it is not deemed to be holding a "security" in the joint venture. Relying on this exemption is different from relying on the "real estate" exemption under Section 3(c)(5)(C) of the Investment Company Act, pursuant to which a fund is not an investment company if most of its investments consist of mortgages and other liens on and interest in real estate and other real estate–type interests. Section 3(c)(5)(C) permits the fund to hold a sizable portion of its assets—up to 20%—in securities.