Articles + Publications | September 2, 2025

REITs, Investment Structures, and Investment Company Status

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This article originally appeared in the September 2025 The Corporate & Securities Law Advisor Insights publication and is reposted with permission.

Real estate investment trusts, or REITs, own more than $4 trillion of commercial real estate assets, according to information from the National Association of Real Estate Investment Trusts, an industry group.[1] Broadly, REITs are pooled investment vehicles or other companies that invest in real estate and meet technical requirements of the Internal Revenue Code of 1986, as amended (the Code). REITs facilitate capital formation for real estate projects and provide easy-to-access exposure to real estate for investors. Recognizing these (and other) benefits, Congress adopted Sections 856-860 of the Code to provide certain beneficial tax treatment to REITs.

Although REITs are creatures of the Code, they are also subject to the federal securities laws, including the Investment Company Act of 1940, as amended (the 1940 Act). An issuer is subject to the 1940 Act if it meets the definition of an “investment company.” REITs are either organized and operated to exist outside the definition of an investment company in the first instance or, if they are within that definition, to satisfy an exemption available to issuers primarily engaged in purchasing and owning real estate and real estate-related assets.

REIT counsel must not lose sight of a REIT’s 1940 Act status. Commonly, REIT counsel are asked to give legal opinions that REITs are not required to register as “investment companies” within the meaning of the 1940 Act in connection with corporate transactions. Such opinions should be rendered with diligence and care, as inadvertent investment company status can result in dire penalties, including voidability of contracts and shareholder rescission rights.[2]

Background to 1940 Act

The 1940 Act regulates investment companies, which are pooled investment vehicles that are primarily engaged in investing in securities. Similar to REITs, investment companies make the benefits of professional management and portfolio diversification available to investors of all types, including retail investors. Investment companies are restricted in the amount of leverage they can incur and are prohibited from engaging in certain transactions with affiliates, among other operational restrictions which would be onerous for a typical REIT.

Fundamental to this discussion is the distinction between securities and real estate assets. The treatment of certain assets is clear; for example, fee interests in real estate and mortgages fully secured by real estate are clearly not securities. Conversely, interests in other companies that invest in real estate, or loans that are not fully collateralized may be securities. Joint ventures may pose challenging questions. While the joint venture (JV) itself may invest in fee interests or fully collateralized mortgages, a venturer's investment is only indirect, often involving multiple tiers of ownership.

For a REIT, issues of investment company status become acute where the proportion of securities in a portfolio approaches the 40% threshold, or where a REIT is otherwise engaged primarily in securities-related activities. A REIT, depending upon the nature of its investment portfolio, may come within the definition of an investment company as contained in Section 3(a) of the 1940 Act, in which event, absent an exemption, registration of the REIT would be required.

Investment Company Defined

As defined in Section 3(a)(1) of the 1940 Act, an investment company is any issuer that:

(1) Engages primarily in investing, reinvesting, or trading in securities (or holds itself out as doing so) (the Primarily Engaged Test); or

(2) Engages in investing, reinvesting, owning, holding, or trading in securities and owns (or proposes to acquire) investment securities whose value exceeds 40% of the value of the issuer's assets (the Asset Test).[3]

Thus, both the Primarily Engaged Test and Asset Test turn on whether and to what extent an issuer is engaged with securities.[4]

The 1940 Act defines "security" in its Section 2(a)(36).[5] Like 1940 Act status, security status is a perennial issue for securities practitioners. Important for these purposes is that the staff of the Securities and Exchange Commission (SEC) generally interprets the term "security" more broadly under the 1940 Act and Advisers Act than it does under the 1933 Act or 1934 Act. This position is based on the notion that investor protection issues may be sharper in these contexts given the intermediation between issuer and investor by a third party, being an investment company (under the 1940 Act) or an investment adviser (under the Advisers Act).[6]

Key to the examination of the character of a REIT's portfolio is the definition of "investment securities," as used in the 40% Asset Test. Investment securities exclude securities issued by majority-owned subsidiaries of the owner that (i) are not investment companies, and (ii) are not relying on the exception from the definition of investment company in Sections 3(c)(1) or 3(c)(7). The 1940 Act defines a majority-owned subsidiary of a person as a company 50% or more of the outstanding voting securities of which are owned by such person, or by another company that is a majority-owned subsidiary of such person.

Joint Ventures

REITs often make investments through JVs. In a typical JV, two or more otherwise unrelated parties pool capital and/or expertise in a common enterprise. While a real estate JV ultimately holds real estate assets, the interest in the JV entity itself may be a security in the portfolio of a REIT for purposes of the 1940 Act.

JVs typically take the form of partnerships or limited liability companies. These types of interests are not enumerated in the definition of "security," Section 2(a)(36), and so are analyzed under the *Howey* framework to determine whether they are investment contracts.[7] In *Howey*, the U.S. Supreme Court defined an investment contract as "a contract, transaction or scheme whereby a person (1) invests his money (2) in a common enterprise and (3) is led to expect profits solely from the efforts of the promoter or a third party."[8]

An interest in a JV may fail the "efforts of others" prong if a joint venturer retains control over the JV. In *Williamson v. Tucker,* the Fifth Circuit found a "strong presumption" that an interest in a JV is not a security and that this presumption is a "difficult burden" to overcome.[9] Nonetheless, courts will look to the "economic realities" of the arrangement. If the contractual language is "specific and unambiguous" as to a venturer's power to exercise a controlling influence over the business and affairs of the venture, then the presumption that the JV interest is not a security will be rebutted only by evidence that it the venturer cannot actually exercise those powers.[10] In particular "[a] joint venture interest can be designated a security if it can be established that:

> (1) An agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership;
>
> (2) The partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or
>
> (3) The partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers."

Regarding the first prong, which examines the relative power between the venturers, courts ask whether a venturer's interest in a JV has the hallmarks of a limited partnership interest (which is a security): limited liability, no ability to dissolve the entity, and no ability to act on behalf of the partnership or otherwise take part in its management.[11]

As to the second prong of the *Williamson* test, a court considers whether the venturers were inexperienced and lacked particular expertise in the type of venture at issue (and not general business experience), such that they would "be relying solely on the efforts of the promoters to obtain their profits." If so, the venturer's interest may be a security.

Finally, if the manager has a "non-replaceable expertise" or a "unique understanding" of the business and a venturer would "be left with no meaningful option" without the manager, then the JV interest may be a security.

The key inquiry in *Williamson* is thus not whether a party actually exercises control, but rather whether it has the ability to do so. This line of reasoning is important to real estate JVs, as many venturers are either capital partners or development partners in practice. But so long as each venturer retains the ability to actually control the JV, the JV interest should not be deemed to be a security under the *Williamson* test. Although *Williamson* was decided under the Securities Act of 1933, the SEC staff has used the *Williamson* framework for purposes of the 1940 Act.[12]

If a JV interest owned by a REIT is found not to be a security for purposes of the 1940 Act, then it will not count against the REIT's 40% bucket for purposes of the Asset Test of the 1940 Act, and should not be regarded for purposes of the Primarily Engaged Test. A REIT, or any other issuer, can thus hold nonsecurity JV interests without limit and without investment company status, provided that it does not otherwise come within the definition of an investment company.

Tiered Structures

JVs often hold real estate indirectly, through the use of one or more intermediary special purpose entities. This fact complicates the investment company analysis described above, but does not necessarily condemn it. The general rule is that a company that invests in interests in other companies investing in real estate is generally deemed to be investing in securities for purposes of the 1940 Act.[13]

However, the staff recognized an important exception to this rule in a 1974 release. In that release, the Division of Investment Management of the SEC published an interpretation on these structures, so-called two-tier real estate companies (Two Tier Real Estate Release).[14] The Division stated that "limited partnership interests owned by a two-tier real estate partnership may be sufficiently analogous to securities issued by majority-owned subsidiaries such that the Division would not recommend an enforcement action to the Commission if (1) an upper company owns more than 50 percent of the limited partnership interests in all the limited partnerships in which it invests and has the right to dismiss and replace the general partners of such underlying companies and the limited partners of such company have the right to dismiss and replace their general partner or partners; (2) such company is not an investment company within the meaning of Section 3(a)(1) of the 1940 Act."[15]

Subsequent no-action guidance on this topic demonstrates that the staff takes a strict approach to the requirements that an upper-tier entity own a majority of the interests in the lower-tier entity, and that the upper-tier entity have dismissal rights as to the manager of the lower-tier entity.[16]

Although the Two Tier Real Estate Release predates the *Williamson* decision, both illuminate the same notion: that control over an entity obviates security status. In *Williamson*, a joint venturer does not hold a security where it can control the JV; and in tiered structures, an upper-tier entity does not hold a security issued by a lower-tier entity where it controls such lower-tier entity by virtue of ownership and dismissal rights.

In our experience, the positions laid out in *Williamson* and the Two Tier Real Estate Release are frequently extrapolated to investment structures with more than two venturers, and/or more than two tiers in an investment structure. The lodestar remains the same, however, and careful attention must be paid to how control is exercised throughout the structure.

Commercial realities may mean that a REIT invests in real estate through JVs or tiered structures that do not satisfy the requirements of *Williamson* or the Two Tier Real Estate Release. In these cases, a REIT may be primarily engaged in investing in securities, or may exceed the 40% Asset Test.

Statutory Exemptions

3(c)(5)(C) Exemption

As initially enacted by Congress in 1940, Section 3(c)(5) originally was intended to exclude from the definition of investment company companies that did not resemble, or were not commonly considered to be, investment companies. These issuers generally held mortgages and other interests in and liens on real estate — not shares of stock or bonds issued by corporate issuers.[17] In 1960, in part in reaction to the adoption of changes to the tax code to give effect to REITs, the SEC stated that the applicability of the Section 3(c)(5)(C) exclusion could be determined only on the basis of the facts and circumstances of the particular REIT, but that generally, any REIT that invested “exclusively in fee interests in real estate or mortgages or liens secured by real estate” could rely on the Section 3(c)(5)(C).[18]

Section 3(c)(5)(C) of the 1940 Act provides an exemption from the definition of “investment company” for issuers not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type, or periodic payment plan certificates, and who are primarily engaged in …[the business of] purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.

The staff of the SEC has taken the position that the exclusion in Section 3(c)(5)(C) may be available to an issuer if:

- At least 55% of its assets consist of “mortgages and other liens on and interests in real estate” (qualifying interests) and the remaining 45% of its assets consist primarily of real estate-type interests (55%/45% asset test);
- At least 80% of its total assets consist of qualifying interests and real estate-type interests;
- And no more than 20% of its total assets consist of assets that have no relationship to real estate (miscellaneous assets).[19]

Qualifying interests include mortgage loans fully secured by real estate, fee interests in real estate, second mortgages secured by real property, deeds of trust on real property, installment land contracts, and leasehold interests secured solely by real property.[20] On the other hand, an interest in the nature of a security in another issuer engaged in the real estate business is generally not a qualifying interest.[21] The crux of the no-action guidance is that the asset be the “functional equivalent of direct ownership in…real estate[.]”[22]

3(c)(6) Exemption

REITs relying on Section 3(c)(5)(C) may invest in real estate through tiered structures as well. Section 3(c)(6) of the 1940 Act excludes from the definition of investment company any company primarily engaged, directly or through majority-owned subsidiaries, in the businesses described in Section 3(c)(5). Thus, a REIT relying on Section 3(c)(5)(C) to avoid 1940 Act in registration in the first instance may effect investments in real estate not only directly as per Section 3(c)(5)(C), but also indirectly through majority-owned subsidiaries.

Such subsidiaries could include JVs (provided that they qualify as a majority-owned subsidiary), but also special purpose entities, property companies, and other entities organized for particular purposes in the real estate ownership structure. In designing tiered structures reliant on 3(c)(6), practitioners should bear in mind the Two Tier Real Estate Release so that lower-tier entities are sufficiently analogous to majority-owned subsidiaries such that upper-tier entities may rely on Section 3(c)(6).

Conclusion

The staff periodically addresses the issue of real estate companies under the federal securities laws. As we’ve seen, there were statements in 1960 (related to REITs), 1974 (the Two Tier Real Estate Release). And as recently as 2011, the SEC issued a Concept Release soliciting comment on various interpretive issues in the application of the 1940 Act to REITs, mortgage companies, and other real estate companies. No formal rulemaking or other staff guidance directly succeeded the Concept Release, although the staff has continued to grant no-action relief under Section 3(c)(5)(C) to expand the scope of qualifying investments.[23]

Avoiding investment company status is essential to the operation of a REIT. A REIT may be an investment company depending on the nature and character of its portfolio. JVs and tiered structures present two structures that deserve particular attention in this context. REITs that are *prima facie* investment companies may nonetheless rely on Section 3(c)(5)(C) and 3(c)(6) to avoid investment company status. The security-to-asset portfolio mix should be monitored on an ongoing basis, and should be considered as one factor in the acquisition and disposition of portfolio assets. The historic development of real estate companies and related regulatory environment has led to a workable, if imperfect, balance.

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[1] NAREIT, Industry Fact Sheet, April 2025 available at https://www.reit.com/investing/investing-tools/nareit-statistical-publications/reitwatch/reitwatch-2025.[2] *See* Section 47(b), 1940 Act.

[2] *See* Section 47(b), 1940 Act.

[3] The definition of "Investment Company" also includes any issuer of face-amount securities of the installment type. These issuers are largely extinct today.

[4] REITs may avoid investment company status under the Primarily Engaged test by holding out as investing in real estate (even if such real estate investment is done through ownership of securities). In assessing whether an issuer is an investment company under the Primarily Engaged test, courts and the SEC look to (1) the issuer's historical development, (2) the issuer's public representations of policy, (3) the activities of its officers and directors, (4) the nature of its present assets, and (5) the sources of its present income. Factors (4) and (5) are considered to be of most importance. *In the Matter of Tonopah Mining Co. of Nevada* (Investment Company Act Release No. 1084, 26 SEC 426 at 427, July 22, 1947).

[5] "Security" means 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, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

[6] The Regulation of Money Managers, Frankel, et. al. § 5.07[B][5].

[7] *Securities & Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946).

[8] *Id.*

[9] *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981) at 421 ("[A] general partnership or *joint venture* interest generally cannot be an investment contract under the federal securities acts.").

[10] *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 241 (4th Cir. 1988). *See also S.E.C. v. Schooler*, 902 F. Supp. 2d 1341, (S.D. Cal. 2012).

[11] Williamson.

[12] *See*, *e.g.*, Pacesetter I L.P., SEC Staff No-Action Letter (Jul. 18, 1986); ML Research and Development Partners I, L.P., SEC Staff No-Action Letter (Sept. 24, 1984); SLM Entertainment, Ltd., SEC Staff No-Action Letter (Oct. 15, 1981); Related Condominium Investors L.P., SEC Staff No-Action Letter (Feb. 11, 1985).

[13] The staff has taken the position that an issuer that is primarily engaged in the business of holding interests in the nature of a security in another person engaged in the real estate business, generally may not rely on Section 3(c)(5)(C). *Companies Engaged in the Bus. of Acquiring Mortgages & Mortg.-Related Instruments*, Release No. 29778 (Aug. 31, 2011).

[14] *Sec. & Exch. Comm'n Release Notice*, Release No. 8456 (Aug. 9, 1974).

[15] *Id*.

[16] For a concise summary of this no action guidance, see Therese L. Miller, Two-Tier Real Estate Limited Partnerships: Avoiding Investment Company Status, C282 ALI-ABA 469, 471 (1988).

[17] *See, e.g.*, H.R. Rep. No. 2639, 76th Cong., 3d Sess. 12(1940) ("Subsection (c) specifically excludes companies dealing in mortgages."); H.R. Rep. No. 1382, 91st Cong., 2d Sess. 17 (1970) ("Although the companies enumerated have portfolios of securities in the form of mortgages and other liens on and interests in real estate, they are excluded from the act's coverage because they do not come within the generally understood concept of a conventional investment company investing in stocks and bonds of corporate issuers.").

[18] *Real Est. Inv. Tr.*, Release No. 3140 (Nov. 18, 1960) (the 1960 REIT Release).

[19] *See, e.g.,* Salomon Brothers, Inc., SEC Staff No-Action Letter (June 17, 1985); Citytrust, SEC Staff No-Action Letter (Dec. 19, 1990); Greenwich Capital Acceptance Inc., SEC Staff No-Action Letter (Aug. 8, 1991).

[20] *See*, *e.g.,* United States Property Investment N.V., SEC Staff No-Action Letter (May 1, 1989) (mortgage loan secured exclusively by real estate in which the value of the real estate was equal or greater than the note evidencing the loan); Division of Investment Management, SEC, *The Treatment of Structured Finance Under the Investment Company Act,* Protecting Investors: A Half Century of Investment Company Regulation (1992) Ch. 1 ("Protecting Investors Report") at n. 345 and accompanying text (mortgage loan in which 100% of the principal amount of each loan was fully secured by real estate at the time of origination and 100% of the market value of the loan was fully secured by real estate at the time of acquisition); United Bankers, SEC Staff No-Action Letter (Mar. 23, 1988) (fee interests in real estate); The State Street Mortgage Co., SEC Staff No-Action Letter (July 17, 1986) (second mortgages); First National Bank of Fremont, SEC Staff No-Action Letter (Nov. 18, 1985) (deeds of trust

on real property); American Housing Trust I, SEC Staff No-Action Letter (May 21, 1988) (installment land contracts); Health Facility Credit Corp., SEC Staff No-Action Letter (Feb. 6, 1985) (leasehold interests).

[21] The Realex Capital, SEC Staff No-Action Letter (Mar. 19, 1984). See also, 1960 REIT Release (A REIT that invests “to a substantial extent in other [REITs] . . . or in companies engaged in the real estate business or in other securities” may not be able to rely on Section 3(c)(5)(C)).

[22] *See* United States Property Investments N.V., SEC Staff No-Action Letter (May 1, 1989) (JV investments in real estate are the “functional equivalents of direct ownership…”).

[23] *See, e.g.*, Redwood Trust, Inc. No Action Letter (Aug. 15, 2019).

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