

Unwanted Affections

Reg D & Real Estate:

Why the SEC and NASD Care Deeply
About Your Clients' Real Estate Offerings

OSB Real Estate & Land Use Section Luncheon
April 11, 2007

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Raising Capital for Real Estate Transactions Generally Involves the Offer and Sale of Securities

- Organizing Real Estate Capital
- Is it a Security: The *Howey* Test
- Why Does it Matter?
- Finding Exemptions: Rule 506 of Regulation D
- Finding Investors
- Counseling Your Client

Organizing Real Estate Capital

- Limited Liability Company/Limited Partnership.
 - Transaction/asset-specific.
 - Sponsor controls the investment:
 - Selects the property and the lender;
 - Negotiates the purchase agreement and loan;
 - Controls the management and disposition of the property.
 - Single sponsor, numerous entities/assets.

Organizing Real Estate Capital

- Investment Funds/Blind Pools.
 - Multiple assets/transactions.
 - Properties acquired after the investment decision.
 - Like LLC/LP, Sponsor controls the investment.
 - Single sponsor may manage numerous funds/pools.

Organizing Real Estate Capital: The New Twist: Tenancy-In-Common

- Boom in TIC investing – Section 1031 exchange
- Similar to LP/LLC:
 - Typically controlled by sponsor;
 - Asset specific;
 - Sponsors often offer/manage numerous assets.
- Investors retain rights prescribed by IRS:
 - Title ownership;
 - Transferability;
 - Right of approval.

Is it a Security?

Investment Contracts & the *Howey* Test

- Expansive definition of "security":

The term "security" means any note, stock, treasury stock, 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, certificate of deposit, or 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. Section 2(a)(1) of the Securities Act of 1933.

- The catch-all: "Investment Contract."

- Orange Groves = Securities: *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

Is it a Security?

Investment Contracts & the *Howey* Test

- The *Howey* test:
 - An investment of money;
 - In a common enterprise;
 - With the expectation of profits from the efforts of the promoter or a third party, where "*the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.*"
- Oregon and Washington tests effectively mirror the federal test.

Is it a Security? LLCs, LPs, Funds, and Pools

- Investors invest money;
- That is pooled with the money of other investors in order to acquire real estate;
- In the hope of profiting from the sponsor's skill:
 - Selecting properties/negotiating purchases;
 - Selecting lenders/negotiating loans;
 - Managing/selecting managers for the properties;
 - Assessing market for sale/negotiating sale.
- Funds/Pools may implicate the 1940 Act.

Is it a Security? Tenancy-In-Common

- Nature of TIC programs.
- Retained Rights, Control, and the *Howey* test.
- Real estate agents' view: TIC investments not necessarily securities.
- Regulators: TIC investments generally securities.
- Impact on investors.
- TIC programs generally involve securities.

Is it a Security?

Nature of TIC Programs

- Radical change in Section 1031 exchanges:
 - Increased pool of potential exchange properties;
 - Explosion in number of TIC programs and money invested.
- Marketing:
 - Tax benefits;
 - A “small part of something big”;
 - Hands-off, passive investments.

Is it a Security?

Nature of TIC Programs

- Take-it-or-leave-it offerings:
 - Sponsor selects the property and lender;
 - Sponsor negotiates terms of the purchase and loan;
 - Sponsor sets the terms of the co-ownership/co-tenancy agreement.
- Investors retain rights (IRS Rev. Proc. 2002-22):
 - Transferability;
 - Sale/lease of the property;
 - Management of the property;
 - Debt secured by the property.

Is it a Security?

Retained Rights, Control, and the *Howey* Test

- *Howey* test: Investment a security if the investor:
 - Retains little power/control (as in an LP/LLC); or
 - Is inexperienced, unknowledgeable, or unsophisticated; or
 - Is dependent on some unique entrepreneurial or managerial ability of the sponsor/manager.
- Do the rights prescribed by the IRS enable a TIC investor effectively to exercise control?

Is it a Security?

Real Estate Agents' View of TIC Programs

- TICs may be structured as non-securities.
 - Direct ownership of real estate not a security;
 - Employ standard commercial real estate practices:
 - Professional property management;
 - Loan concessions;
 - Co-tenancy agreement.
 - Sophisticated or accredited investors only.
 - ***Control – Investors Exercise Real Control:***
 - Management, debt, sale/disposition;
 - Sponsor defers to decisions of TIC investors.

Is it a Security?

Real Estate Agents' View of TIC Programs

- Policy-based arguments:
 - Real estate agents excluded from real estate market;
 - Broker-dealers not qualified to sell real estate;
 - Slippery Slope: Is all real estate a security?
 - Exemptions overly burdensome/not suited to real estate context;
 - Adverse impact on real estate markets of rescission/other buyer remedies.

Is it a Security?

Real Estate Agents' View of TIC Programs

- Lobbying efforts
 - Industry organizations;
 - Utah state exemption for TIC programs:
 - Exempt if:
 - no more than 10 co-owners, or
 - majority may terminate management agreement, and
 - complies with any requirements imposed by state real estate regulator.
 - Federal securities laws still apply.
 - “Real estate” regulations may be preempted under NSMIA.
 - Oregon SB 449.

Is it a Security?

Regulators' View of TIC Programs

- NASD: Private industry-wide regulator of securities brokers/dealers sanctioned by the SEC under the '34 Act.
- NASD Guidance (NTM 05-18):

“TIC interests are generally investment contracts because the tenants in common invest in an undivided fractional interest in the rental real property by pooling their assets and sharing in the risks and benefits of the enterprise, while obtaining profits derived predominantly from the efforts of others, such as through contracts concerning leasing, management and operation of the acquired property. In addition to managing the property, TIC sponsors typically structure the TIC and negotiate the sale price and the loan.”

Is it a Security?

Regulators' View of TIC Programs

- Oregon and Washington state regulators generally have aligned with the NASD's position.
- SEC – No explicit guidance:
 - Triple Net Leasing No-Action Letter
 - Issued prior to IRS Rev. Proc. 2002-22;
 - Proposed sale of TIC interests with 10-15 year master lease to affiliate of sponsor;
 - SEC staff viewed the proposal as involving security.
 - Guide to Broker-Dealer Registration
 - In TIC context, withdrew no-action positions regarding sales of condominiums coupled with other services;
 - Cited the NASD's position.

Is it a Security?

TIC Programs Typically Involve Securities

- Typical TIC program involves an investment contract:
 - Sponsors want and need control:
 - Offer interests on a take-it-or-leave-it basis;
 - Retain call option.
 - TIC programs marketed as passive investments.
 - Targeted investors don't want control.
 - Investment decisions based on the sponsor, the business plan, and the property;
 - TIC investors not capable of exercising real oversight.

Why Does It Matter?

- Federal and State registration required if no exemption is available.
 - Expensive.
 - Burdensome oversight and reporting requirements.
 - Rescission (Strict Liability).
 - Civil penalties.
- Substantial limitations on sales/investor solicitation practices.

Why Does It Matter?

- Anti-fraud provisions of state and federal securities laws apply:
 - Substantial disclosure requirements.
 - Potential civil and criminal liability.
 - Far-reaching liability – may extend to lawyers involved.
- Regulatory scrutiny/action likely to increase.

Finding Exemptions: Regulation D

- Certain “private placement” exemptions set forth in the '33 Act and in state securities laws.
- Regulation D
 - “Safe harbor” established by SEC;
 - Exempts certain private placements from federal registration requirements;
 - Rule 506 the most useful and the most common.

Finding Exemptions: Regulation D Rule 506

- Benefits:
 - No limit on the size of the placement.
 - No limit on the number of “accredited investors”:
 - Individuals: \$1 million net worth (individual or joint) or income of at least \$200,000 (or \$300,000 joint);
 - Entities: Varies depending on type of entity.
 - No prescribed disclosure to accredited investors.
 - No federal or state registration required: only Form D notice filing.
 - State registration requirements preempted by Section 18 of the '33 Act.

Finding Exemptions: Regulation D Rule 506

- Limitations:
 - No general solicitation or advertising.
 - State and federal anti-fraud laws apply.
 - Limited to 35 non-accredited investors.
 - Non-accredited investors must be sophisticated.
 - Extensive disclosure required to non-accredited investors.
 - Securities are restricted and cannot easily be resold by investors.

Selling Private Placements: Prohibition on General Solicitation

- Applies to nearly all exempt offerings.
- No advertising or broadcast communications.
 - Generic;
 - Investors attracted must be excluded from current or contemplated offerings.
- Pre-existing relationship requirement:
 - SEC No-Action Letters;
 - Relationship must precede any current or contemplated offering;
 - Issuer (or its agent) must be aware of the investor's sophistication and financial (and other) circumstances.

Selling Private Placements: Use of Brokers and Finders

- Broker-Dealer: Any person/entity in the business of buying and selling securities.
 - State and Federal registration required.
 - Applies to private placements.
- Finders: One who merely brings the investor and issuer together is not a broker-dealer.
 - No solicitation, negotiation, or execution.
 - No commissions or transaction-based compensation.
 - Registration not required.

Selling Private Placements: Use of Brokers and Finders

- Issuer Exemption (Rule 3a4-1)
 - “One-off” or very infrequent offerings.
 - May not routinely engage in securities transactions;
 - Must “primarily perform” duties unrelated to securities transactions.
- Investor Recourse.
 - Right of rescission against an unregistered broker-dealer.
 - May have a right of rescission against the issuer.

Selling Private Placements: Suitability and Investor Qualification

- Accredited Investor Status:
 - Due diligence: reasonable belief.
 - Determine prior to investment.
- NASD Suitability Requirements:
 - Determine prior to “recommending” a security.
 - Accredited status not enough, must consider:
 - Investor circumstances (finances, age, diversification, etc.);
 - Risk tolerance;
 - Investment objectives;
 - Overall sophistication.

Selling Private Placements: TIC Issues

- Suitability
 - Tax aspect drives most TIC investments.
 - Section 1031 exchange “time crunch.”
- No payments to unregistered real estate agents:
 - NASD Disciplinary Actions.
 - “Welton Street” SEC No-Action Letter permits certain compensation for sales of TIC interests:
 - Real estate agents must be registered with the NASD.
 - No portion may go to agents’ real estate firm.
 - TIC-related activities must be conducted in separate office.

Counseling Your Client