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WHEN IS REAL ESTATE INVESTMENT A SECURITY? WHY SHOULD YOU CARE?

As a practical matter, documenting compliance with federal and state securities laws is irrelevant where the underlying business is successful and the equity holders' expectations are met. Unfortunately, real estate development, like all business segments, has bumpy periods and some real estate projects fail the projected return. When that happens, there is inevitably blaming. Outside investors, those most disconnected to the day to day operations, insist their investment return was not suggested, it was promised! Instead of viewing securities law as the bane of your client's existence, tell him or her to think of compliance as something that allows the issuer (and promoters) to document what they said, who they said it to and when. Counsel can help them control the risks of claims from unhappy investors based on "hindsight".

Regulation of Securities - an Overview

The word "securities" means any number of enumerated items under the Securities Act of 1933 and the Securities Exchange Act of 1934, as amended. Securities include stocks, bonds, debentures, notes and investment contracts. An investment contract means a contract, transaction or scheme whereby a person: (i) invests his or her money; (ii) in a common enterprise; (iii) is led to expect profits; (iv) solely from the efforts of a third party; and (v) risks loss. The sale of securities, such as stock, warrants for stock, membership interests in an LLC or limited partnership interests, is regulated by each state as well as the federal government. Regulation focuses on three key variables: the security (or transaction) itself, the persons and entities who sell the security, and the disclosures made to investors about the security.

Every security either must be registered with the SEC or qualify for an *exemption* from registration under Federal law. In addition, the security either must be registered or exempt from registration in all applicable states, i.e., states in which residents are offered or sold the securities, or that have sufficient contacts with the sales process. Unfortunately, state registration exemptions differ dramatically from state to state. A federal exemption does not guarantee a state exemption (or vice versa), nor does an exemption in one state mean that a comparable exemption will be available in another.

The issuer must first try to identify those states in which offers will be made. A state-by-state analysis of the exemption requirements for the registration of the security then can be prepared. This state "blue sky" analysis is critical because of the wide variation of exemptions and the differences in filing requirements, with the states differing in whether the filing is triggered by "offers" or "sales" and a few states requiring a pre-offer filing.

In addition, the *person* selling the securities must be registered with the state and federal government as a *broker-dealer* or agent unless an applicable exemption from registration in those capacities is available. An exemption from registration for the sale of the securities at either the state or federal level does not mean that the person selling the securities is exempt from registration as a broker-dealer. The term "person" includes the issuer and any individuals involved in the selling process. Broker-dealer and agent exemptions vary from state to state and may not parallel federal exemptions; even if a federal broker-dealer exemption is available, there may not be a comparable state exemption.

Specific Exemptions for an Offering.

Federal and state registration of any equity offering is expensive and time consuming. To avoid both problems, clients are well advised to find an exemption from registration. The most basic exception is a "private placement", either under Regulation D or the statutory provisions of Section 4(2) of the Securities Act of 1933, as amended, each of which permits the raising of funds without registering the transaction with the SEC.

The requirements for the Section 4(2) exemption are vague…usually too vague for comfort. The statutory language provides that a “transaction ... not involving any *public* offering” is exempt from registration requirements. Case law and administrative pronouncements suggest that the exemption may be available where people to whom the securities are offered (offerees), as well as actual purchasers, have substantial financial means and are capable of evaluating the merits of the investment. Additionally, offerees either must have “access” to all material financial and other pertinent information about the issuer and its affiliates through their economic bargaining power or be provided with such information in a formal, documented manner. Under Section 4(2), the equity must be acquired for investment purposes and may not be resold for an indefinite period of time, which for persons not closely associated with the issuer and its affiliates is generally not less than two years. If equity is resold by an original investor in the private placement, the equity being resold either must be registered or exempt from registration at that time.

Viewed most restrictively, a private placement under Section 4(2) requires an offeree to meet certain wealth and sophistication standards. Furthermore, there is an ill-defined limit (perhaps thirty-five or fewer) on the total number of offerees. The issuer must not use any form of public solicitation or general advertising in connection with the offering and must demonstrate that each purchaser:

- had enough knowledge and experience in finance and business matters to evaluate the risks and merits of the investment (the “sophisticated investor”), or was able to bear the investment’s economic risk;
- had access to the type of information normally provided in a prospectus; and
- agreed not to resell or distribute the securities to the public.

As the number of purchasers increases and their relationship to the company and its management becomes more remote, it is more difficult to show that the Offering qualifies for the exemption.

The Offering may nonetheless comply with Regulation D, which limits the number of purchasers (rather than offerees) and/or the dollar amount of the securities sold. Regulation D is a "safe harbor" and provides clear guidelines for what is and is not an exempt offering under Section 4(2) of the Securities Act. The "safe harbor" exemptions available at the federal level under Regulation D are found in Rules 504, 505 and 506.

To confuse things a little more, in 1996, Congress enacted law that preempts certain state blue sky laws regulating securities offerings with the National Securities Markets Improvement Act of 1996 (NSMIA). NSMIA preempts state laws, rules, regulations, or orders that (1) with respect to registration or qualification of securities transactions, directly or indirectly apply to a covered security or a security that will be a covered security upon completion of the transaction, (2) directly or indirectly prohibit, limit, or impose any conditions on the use of any offering document prepared by the issuer or any proxy statement, report to shareholders, or other disclosure document required to be filed with the SEC or any national securities organization registered under Section 15A of the Securities Exchange Act of 1934, except that this subsection does not apply to the laws, rules, regulations, or orders of the state of incorporation of the issuer, or (3) directly or indirectly prohibit, limit, or impose conditions on the offer or sale of any covered security. NSMIA applies only to "covered securities", however, and a "covered security" does not include a security with respect to a transaction exempt from registration pursuant to Rule 504, Rule 505 or Regulation A, because such rules were promulgated under Section 3(b). A "covered security" includes only a security with respect to a transaction exempt from registration under Rule 506, adopted under Section 4(2).

Rule 504 permits the offer and sale of up to $1 million of securities over a 12 month period to an unlimited number of persons without regard to their financial status. Rule 504 does not require any disclosure document. Nevertheless, in light of the express applicability of the anti-fraud provisions (addressed later in the materials), counsel, as a matter of written policy, should recommend against proceeding with any offerings without disclosure documents.

Rule 505 permits the sale of up to $5 million of securities to an unlimited number of accredited investors and to not more than thirty-five (35) non-accredited investors. Again, this $5 million amount is reduced by all sales within the twelve (12) months before the start of and during the Offering. In order to sell to non-accredited investors, a disclosure document is required, with specific requirements as to the level of narrative and financial statement disclosure. Audited financials will be required if the issuer has historic operations.

Rule 506 permits the sale of an unlimited dollar amount of securities to an unlimited number of accredited investors and to not more than thirty-five (35) non-accredited investors. In order to sell to non-accredited investors, Rule 506 requires specific narrative and financial information that is essentially the same as the narrative information required in Rule 505. Non-accredited investors in a Rule 506 offering must be "capable of evaluating the merits and risks of the prospective investment". Thanks to NSMIA, in theory, Rule 506 eliminates many blue sky law hurdles to capital formation. Unfortunately, state regulators and courts have repeatedly challenged the assertion of NSMIA pre-emption where issuers claim reliance on, but cannot prove actual compliance with, the Rule 506 exemption.

At the state level, if the issuer wants to avoid any notice filing, it can use a "Small Issuer Exemption" in Pennsylvania found in Section 203.187 and a similar extension in New Jersey found in Section 49:3(b)(9) as long as there will be no more than 10 investors. Our clients usually use an exemption afforded by Section 203(d) of the Pennsylvania's Securities Law of 1972. Section 203(d) permits the sale of up to twenty-five (25) limited partnership interests within a period of 12 months, and under Section 203(e) there can be offers to fifty (50) persons. These levels of sales and offers, respectively, can be increased under Regulation 204.010, which provides that if the federal exemption relied upon is either Rule 505 or Rule 506, there can be an unlimited number of purchasers so long as the "Pennsylvania accreditation" standards (as described below) are met. The registration exemption also requires a specific representation from the investor as to his "investment intent" and, under Pennsylvania law, purchasers will not be permitted to re-sell their equity for a twelve (12) month period.

Pennsylvania's Section 203(d), however, specifically prohibits "general solicitation" through public media advertising, mass mailing, internet or other means in connection with soliciting sales of the securities. Section 203(t), as an alternative, allows the use of tombstone advertisements in the offering and sale of securities to Pennsylvanians if the issuer is using 504 or 506 of Regulation D and provided (i) only accredited investors, as that term is defined by federal law, purchase the securities; (ii) the issuer specifies in any advertisement, communication, sales literature or other information which is publicly disseminated (including electronic transmissions) that the securities will be sold only to accredited investors; and (iii) the issuer does not engage in any solicitation of prospective purchasers by telephone until the issuer has reasonable grounds to believe that the person solicited is an accredited investor.

The definition of "accredited investor" at the federal level includes the following persons:

- Ø any insider of the issuer (director, manager, certain officers);
- Ø any natural person with an individual net worth, or joint net worth with his or her spouse, at the time of the purchase exceeding $1,000,000; and
- Ø any natural person who had an individual income in excess of $200,000 in each of the two most recent years or a joint income with his or her spouse in excess of $300,000 in each of those years and has the reasonable expectation of reaching the same level of income in the current year.

There are different federal requirements for corporations, partnerships, trusts, and non-profit organizations. Generally, these entities will be accredited investors only if: (1) all of the equity owners are accredited investors (not available for trusts), or (2) the entity has assets (as distinguished from net worth) in excess of $5,000,000 and was not formed for the purpose of making this investment. Employee benefit plans are accredited investors only if: (a) the investment decision is made by a plan fiduciary that is a savings and loan association, bank, insurance company, or registered investment advisor, (b) the plan has total assets in excess of $5,000,000, or (c) if a self-directed employee benefit plan, its investment decisions are made solely by one or more individuals who are accredited investors.

Although an accredited investor for federal purposes will also be an accredited investor for Pennsylvania purposes, Pennsylvania's Regulation 204.010 (which is available to issuers

using Section 203(d) and 203(e) of Pennsylvania's Securities Law) has a separate and less demanding accreditation standard. Regulation 204.010 provides that if the federal exemption is based on Rule 505 or 506, the issuer may sell to an unlimited number of persons, provided that the purchaser has a net worth, or where applicable, a joint net worth with his or her spouse (in either event exclusive of home, furnishings and automobiles) at the time of sale of five (5) times the purchaser's total purchase price. This less demanding formula for determining the number of subscribers is not, however, available for an offering using Section 203(t) (i.e., using advertisements or the internet in any fashion).

Blind Pools

In New Jersey, "blind pools" are disliked and subject to a stop order denying effectiveness to, or suspending or revoking the effectiveness of, any registration if the New Jersey Securities Department Bureau Chief finds that such an order is in the public interest. A "blind pool" is defined as an offering of securities in which 65% or more of the proceeds are not dedicated to the purchase of specific assets, specific projects to be undertaken or business to be conducted unless certain exemptions to the definition apply. Pennsylvania has no such statutory provision.

To be sure to avoid New Jersey's possible sanction, it may be best (i) to allocate no more than 30% to purchase/sale of real estate activities; (ii) to describe with as much specificity as possible the potential use of proceeds going forward; and/or (iii) to give the Members or Limited Partners the regular opportunity to participate in future investment decisions by requiring a 51% LP vote to proceed from time to time. This last possible characteristic of the issuer's ongoing operations is a further opportunity to avoid "Investment Company" rules and regulations that may be found to apply in a true "blind" fund.

Advertising and Solicitation.

Neither the issuer nor anyone acting on its behalf may engage in mass mailing or issue press releases that discuss the existence of the private placements until after the offerings have been conducted and all sales to investors have been finalized. Though not the only way to demonstrate an absence of general solicitation, a conservative interpretation of the SEC's view is that potential investors should be people with whom the issuers, their directors, officers or full-time employees have a "pre-existing business relationship." So called "No-Action letters" addressing the SEC's interpretation of general solicitation suggest that the SEC looks for facts to determine whether the offeror's pre-existing relationship with the offerees was of the type that would permit the issuer to be aware of the financial circumstances or sophistication of the persons with whom the relationship exists or was otherwise of some substance and duration. Satisfactory response to a questionnaire including information about the respondent's employment history, business experience, business or professional education, investment experience, income, net worth or sophistication may, in certain circumstances, be sufficient to establish a substantive relationship.

Internet Use and General Solicitation.

An internet offering presents additional challenges since it is accessible to anyone with on-line capability. The jurisdictional question of whether an offering document on the internet

constitutes an offering in all 50 states has not yet been resolved. State securities regulators have maintained that such an offer is subject to state regulation. Consequently, before embarking on an internet direct offering, a review needs to be made of the blue sky laws in all states either to find an exemption or to register. Those state laws also need to be reviewed to determine whether the issuer has available an exemption from that state's broker-dealer registration requirements or will be required to register as such in that state in connection with a direct public offering.

State regulators in Pennsylvania took the lead and provided that an internet offering is exempt from Pennsylvania registration requirements if (1) the screen indicates that the securities are not being offered to persons in Pennsylvania, (2) the securities are not offered to Pennsylvanians via other means, and (3) no sales of securities are made in Pennsylvania as a result of the Internet offering. See Order of the Pennsylvania Securities Commission *In re: Offers Effected through Internet that Do Not Result in Sales in Pennsylvania,* 2A Blue Sky Law Rep. (CCH) ¶48,684U at p. 43,689-143.

The North American Securities Administrators Association (NASAA) encouraged all states to adopt similar measures when the following conditions are present:

- Ø the Internet offer indicates, directly or indirectly, that the securities are not being offered to the residents of a particular jurisdiction; and
- Ø an offer is not otherwise specifically directed to any person in a jurisdiction by or on behalf of the issuer of securities.

On the issue of using the internet in private placement transactions, in the *IPOnet SEC No-Action Letter* (July 20, 1996), the SEC staff agreed that the offering of securities to pre-qualified and accredited investors via a password-protected website did not constitute general solicitation or advertising. In IPOnet, potential investors were required to submit completed questionnaires, which were reviewed by IPOnet before access was granted.

The IPOnet ruling was extended by the *Lamp Technologies, Inc. SEC No-Action Letter* (May 29, 1997), which permitted a hedge fund operator to use a similar procedure to provide online access to offering information. Because of its concern that some third parties who were not broker-dealers may have been interpreting IPOnet and Lamp Technologies too liberally, the SEC issued an interpretive release in April, 2000 (Release No. 33-7856). This release cautioned that third party service provider websites raise serious concerns as to whether the offerings they facilitate involve general solicitations. The release warned that the SEC's interpretation of whether a "pre-existing, substantive relationship" existed typically involved broker-dealers and their customers because the traditional relationship between those parties requires that the broker-dealer deal fairly with and make suitable recommendations to the customer. The SEC has long stated, however, that whether general solicitation exists is dependent on the facts and circumstances of each case and therefore there may be situations where a third party other than a broker-dealer could establish that a pre-existing, substantive relationship exists to overcome the prohibition on general solicitation. The SEC urged third party website operators to work with the SEC to resolve any securities laws issues.

On the issue of whether a person other than a broker-dealer can establish "pre-existing substantive relationships" with investors, *Agristar Global Networks, Ltd. No-Action Letter*

(February 9, 2004), provides some guidance. In this case, since the SEC declined to approve an issuer's plan to solicit existing customers from its database. Commentators suggest that the SEC was concerned that the issuer could not properly assess the sophistication level of the customers from the information contained in the database and that perhaps the SEC was put off by the large number of potential investors that would be contacted (at least 2,000). Other inquirers were more successful in obtaining No-Action letters notwithstanding their lack of broker-dealer status. Typically, these inquirers were financial companies or related to financial companies.

In moving forward with an offering wishing to use the internet, we recommend the following:

- Ø The issuer may advertise the offering on its website using a brief (one page) pre-offering summary of general terms. This summary must state that the equity is being offered only to accredited investors in certain states (i.e., those states for which we have done a Blue Sky analysis). We do not recommend posting the offering materials on your website, even if you restrict the user's ability to print or copy the file, unless access is available only to accredited investors on a password-restricted basis (see below).

- Ø The issuer's website may contain a link to a detailed questionnaire for prospective investors to print out, complete and return to the issuer, together with related certifications.

- Ø Once the issuer receives a completed questionnaire, it should review it carefully and otherwise conduct the due diligence believed to be appropriate to evaluate the prospect for financial stability and investment sophistication.

- Ø After the issuer has determined that a prospect is an accredited investor, it may deliver the offering material by mail or by password-protected access via the website. If the issuer opts to deliver the material electronically, there may be additional hoops, such as ensuring that the investor has the requisite software (e.g., Adobe Acrobat) to download and view the file. Keep in mind that by delivering the offering materials electronically, you lose control over the number of copies that are in circulation.

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<u>Proposed Changes to Regulation D</u>

The SEC has proposed a new Regulation D exemption under Rule 507, permitting "large accredited investors" to purchase an unlimited dollar amount of securities and reducing the integration period for issuers to qualify to 90 days. A "large accredited investor" includes entities with at least $10 million of investments, or an individual with at least $2.5 million of investments or an annual income of at least $400,000 ($600,000 with his or her spouse), adjusted for inflation every five years starting in 2012. In addition to meeting either the net worth or income requirements, an investor must have at least $750,000 in investments, excluding an owner-occupied home. Unlike the current exemptions under Regulation D, the issuer under this new Rule 507 exemption would be permitted to make a limited announcement of the offer in print and on the internet, including things such as the name and address of the issuer, a brief description of the issuer's business and information on the offering.

Who can sell the equity?

Federal law and the law of every state provides that no compensation can be given or paid, directly or indirectly, to any person in connection with a sale of securities unless the compensation is given or paid in connection with a sale made by a registered (licensed) broker-dealer. See PA Section 203(s)(iv). Registered broker-dealers (at the federal and state level) can always sell securities, subject to applicable law. An exemption from registration and sponsorship, usually referred to as the "issuer" exemption, is available to individuals who are not engaged in the business of selling securities as their regular business under certain circumstances. Under very limited circumstances, a "finder's fee" is permitted for an isolated introduction that results in the sale of securities.

Similarly, for federal purposes, there is a narrowly-defined exemption available only if the issuer and its affiliates sell securities only once in a twelve-month period and receive no finder's fee or commission directly related to their sales success. Neither the General Partner nor any entity under common control should have sold securities within the past twelve months, nor will any one or more sell securities within the next twelve months. If the issuer's plans change and it decides to sell securities or a related entity's securities again in the next twelve months, the alternatives available under the broader concepts of the issuer exemption outside of the safe harbor should be addressed.

Under federal law, the equity can be sold by the issuer or its General Partner's executive officers, directors, and full-time employees who perform substantial duties for the General Partner other than selling these securities. There are other highly technical federal conditions relating to individuals involved in the selling effort. No such person can: (1) be subject to a "statutory disqualification"; or (2) be compensated (directly or indirectly) by paying commissions or other compensation based on sales of the securities unless a registered broker-dealer. Note that Pennsylvania and certain other states have a formula under which they calculate the maximum commission payable to broker-dealers in any offering.

Many states also have disqualification standards relating to those involved with the selling process. Many (but not all) states exempt issuers and their employees who sell their own securities in a transaction that is exempt from federal registration. This process is part of state "blue sky" compliance.

Disclosure Obligations

Exemption from registration does not relieve the issuer or its affiliates, (the General Partner and any Limited Partner for example) from the state and federal *anti-fraud provisions*, which require the issuer to provide all material information about the offering and the investment to allow investors to make an informed investment decision. State and federal securities laws require the issuer to provide investors with full, fair, and complete disclosure of all "material" facts about the offering and the issuer and its related entities that will be involved in operations of the issuer, their management, business, operations, and finances. Information is *material* if a reasonable investor would consider the information important in making an investment decision. While materiality is a difficult concept to define precisely, a good shorthand is that a fact is

"material" if you do not want to disclose the information because potential investors who know about it would not buy the equity. Facts which are disclosed must be developed fully.

The federal antifraud provisions arise primarily from the well known Section 10(b) and Rule 10B-5 of the Securities Exchange Act of 1934 (Exchange Act), as well as the lesser known Section 12(2) of the Securities Act. If the offering is sold exclusively to accredited investors, Rule 502(b)(1) provides that no specific information need be provided to satisfy the registration exemption. Even in a transaction limited to accredited investors, however, the prudent counsel and issuer are well advised to provide written materials as a way to indicate compliance with the antifraud provisions of the state and federal securities laws, particularly providing information in sensitive areas such as risk factors, conflicts of interest, source and use of funds, and compensation and other ownership and benefits to management and promoters. Prepare, with information provided by the client, a private placement or confidential offering memorandum ("PPM" or "COM"). Keep track of each offerees receipt of the disclosure materials and make sure the risks of loss are indentified clearly. If projections are used, include the following warning in bold: "The projections contained herein are based on numerous assumptions relying on certain factors over which [the Company] has no control, and accordingly these projections are not guaranteed or warranted and no assurance can be given to investors about the returns that may be realized by an investment in [the Company]. Any reliance on the contents contained herein shall be solely at the recipient's risk and recipients are expected to undertake their own due diligence, inspections, investigations and assessments as to the feasibility of the business." And, be prepared to supplement the PPM or COM as facts evolve. It is extremely important that the COM be kept current to reflect material developments after the initial publication. For these purposes, the issuer should consider "a material development" to be a development which a potential investor would consider meaningful in making a decision to invest.

Accreditation; Investment Intent.

The issuer has the burden of establishing an exemption from registration. The failure to satisfy even one element of the exemption (e.g., under Rule 506 selling to more than thirty-five non-accredited investors or under Pennsylvania's 203(t) selling to any non-accredited investor) could destroy the availability of the exemption for the entire offering - not just the single offer or sale in question. With respect to any exempt offerings, the issuer must reasonably believe after reasonable investigation that the purchasers are purchasing for "investment". This requirement can be met by representations by subscribers in a Subscription Agreement. However, if the issuer has any information to the contrary as to any given purchaser regarding investment intent or financial sophistication, the specific knowledge would probably control over any written representation which might be made to the issuer as the issuing entity.

"Bad Boy" Provisions.

Certain exemptions from registration are not available if the issuer, or if any of its affiliates, has engaged in certain unsavory conduct (been a "Bad Boy"), generally within the past five (5) or ten (10) years, such as follows: (a) is subject to any order, judgment or decree relating to any conduct or practice in connection with the sale of securities; (b) has been convicted of a felony or a misdemeanor in connection with the sale of securities or any felony involving fraud or deceit such as forgery, embezzlement, obtaining money under false pretenses, etc.; (c) is subject to any order, judgment or decree issued by any state securities administrator, the SEC, or

the United States Postal Service in which fraud, deceit or registration violations were found; or (d) is subject to an order barring or suspending membership in any self regulatory organization registered under the Securities Exchange Act of 1934. Questions include whether the issuer or its affiliates have engaged in any "dishonest or unethical practices in the securities business or has taken unfair advantage of a customer" at any time in the preceding ten (10) years.

Record Keeping.

The issuer must maintain detailed records relating to the offering. It must establish internal procedures and checklists that make it easier to track all aspects of the selling process in order to comply with the rules concerning the conduct of the offering and the information sent to, and received from, prospective investors. Only specifically designated persons should distribute the COM, each copy of which should be numbered. Copies for internal use also should be numbered. A list of each person to whom the document is sent should be maintained and should indicate the date of transmittal and whether it is for internal use, bankers, purchaser representatives, lawyers, accountants, or specified investors. A file should be maintained for each potential investor containing accurate records of correspondence, meetings, phone calls, etc., to record what questions were asked, what additional material was provided, and what due diligence was performed to determine each investor's sophistication and accreditation. These records are to be kept for at least three years.

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