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Real Estate Private Placement Offerings Under New Regulation A+ and Regulation D, Rule 506
Leveraging New Capital Raising Opportunities for Real Estate Fund Sponsors and Developers

WEDNESDAY, JULY 1, 2015
1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today’s faculty features:

Kenneth A. Kecskes, Partner, Fox Rothschild, San Francisco & Los Angeles

David I. Thompson, Member, Dickinson Wright, Phoenix
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Using Regulation A+ to Fund Real Estate Projects

Kenneth A. Kecskes, Esq.
Partner
San Francisco

These are educational materials, not legal advice.
Background

• Real estate and securities laws
  • Offerings of interests in real estate holding companies, such as LLCs, LPs, and corporations trigger securities laws
  • Offerings of participations in real estate secured loans
  • Almost any passive real estate investment can be an “investment contract.”
  • “The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.” SEC v. W.J. Howey, 328 U.S. 293, 301 (1946).
Structuring for Exemptions

• Structure transactions to fit within exemptions
• Old “Regulation A” exemption
  – Key Benefits
    • solicit non-accredited investors (if permitted by state laws)
    • securities freely transferable
  – Key Drawbacks
    • Low $5 million annual limit
    • SEC and state “Blue Sky” review uncoordinated
  – Practical Result
    • Rule 506 of Regulation D preferred
Federal JOBS Act

• Signed by President Obama in 2012 to encourage small business and startup funding
• Directed the SEC to:
  – Eliminate the ban on general solicitation and general advertising in Rule 506 offerings when sales are only to “accredited investors”
  – Establish a small offering exemption for crowdfunding
  – Create a new exemption for offerings up to $50 million
Regulation A+

- SEC finalized amendments to Regulation A in March 2015
- Now known as Regulation A+
- Regulation A+ has two “tiers”
  - Tier 1
  - Tier 2
## Tier 1 and Tier 2 Summary

<table>
<thead>
<tr>
<th></th>
<th>Tier 1</th>
<th>Tier 2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Offering limit</strong></td>
<td>$20 million annually</td>
<td>$50 million annually</td>
</tr>
<tr>
<td><strong>Investment limit on selling security holders</strong></td>
<td>$6 million annually</td>
<td>$15 million annually</td>
</tr>
<tr>
<td><strong>Limits on investors?</strong></td>
<td>No limits (i.e., can sell to non-accredited investors)</td>
<td>Limits for non-accredited investors only</td>
</tr>
<tr>
<td><strong>Restrictions on resale?</strong></td>
<td>None, except affiliates</td>
<td>None, except affiliates</td>
</tr>
<tr>
<td><strong>SEC filing requirements</strong></td>
<td>File Form 1-A</td>
<td>File Form 1-A</td>
</tr>
<tr>
<td><strong>“Blue Sky” review?</strong></td>
<td>Yes, SEC and state review</td>
<td>No, only SEC review*</td>
</tr>
<tr>
<td><strong>“Test the waters”</strong></td>
<td>Yes, prior to filing Form 1-A</td>
<td>Yes, prior to filing Form 1-A</td>
</tr>
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</table>
## Tier 1 and Tier 2 Summary

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<tr>
<td><strong>Offering communications</strong></td>
<td>Sales materials can be used before and after filing Form 1-A and after qualification</td>
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</tr>
<tr>
<td><strong>Financial statements</strong></td>
<td>Unaudited balance sheet and income statement for two years, with some exceptions</td>
<td>Audited financial statements required</td>
</tr>
<tr>
<td><strong>Ongoing reporting</strong></td>
<td>Basically none other than termination report</td>
<td>Yes, current reports, semi-annual reports, and annual reports until obligations terminated or suspended</td>
</tr>
</tbody>
</table>
Eligible Issuers

- “Organized” and “principal place of business” in US or Canada
Ineligible issuers

- SEC-reporting companies
- Investment companies required to be registered under Investment Company Act of 1940
- Blank check companies
- Fractional undivided interests in oil & gas
- Issuers who have not filed ongoing reports required by Regulation A for two years
- Issuers who have had the SEC deny, suspend or revoke registration within five years
- “Bad actors”
Non-accredited investors

• Tier 1 – No investment limit
• Tier 2 – Limits for non-accredited investors only:
  (i) 10 percent of the greater of annual net income or net worth (for natural persons) or
  (ii) 10 percent of the great of annual revenue or net assets at fiscal year end (for natural persons).
“Test the Waters”

• Informal way to solicit interest
• Publicize, including on social media or by email
• Must be accurate and not misleading
• Include legends regarding status of offering
• Cost-effective way to gauge interest
• “Testing” can be done until offering has been “qualified” for fundraising by the SEC
Secondary Sales Limits

• Selling securityholders can sell up to 30 percent of the aggregate offering price (offering size)
  – At time of initial offering
  – Within following 12 month period
• Affiliate securityholders limits:
  – Tier 1: $6M for 12 months following initial qualification
  – Tier 2: $15M for 12 months following initial qualification
• Non-affiliate securitiesholders
  – No secondary sales limit
  – But sales will be aggregated with sales by the issuer and affiliates for purposes of maximum offering limitation
Tier 2: Mini-IPO

- May list securities on national exchange by filing Form 8-A, a short-form registration statement
- Registration would thereafter require 12(b) reporting
Eligible Securities

• Eligible securities are defined as:
  – Equity securities, including warrants
  – Debt securities
  – Debt securities convertible or exchangeable into equity interests, including any guarantees of such securities

• “Asset-backed securities” as such term is defined in Item 1101(c) of Regulation AB are not eligible securities.
“Asset-backed security”

Regulation AB defines an “asset-backed security” as:

• “a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets,”
• “either fixed or revolving,”
• “that by their terms convert into cash within a finite time period,”
• “plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders . . .”
Structuring Alternatives: Debt

- Real estate secured debt (single asset, not a pool of loans)
- Unsecured debt
Mezzanine Debt

• A mezzanine loan secured by LLC membership interests or LP interests
• LLC or LP holds a single asset
• Would several held assets constitute a pool?
Structuring Alternatives: Equity

- Preferred equity
- Common equity

```
Investors

Holding Company

Asset  Asset  Asset
```
Filing Requirements

- File SEC Form 1-A for both Tier 1 and Tier 2
  - Basic issuer information
  - Identify material risks
  - Explain use of proceeds
  - Disclosures about executive officers and comp
  - Beneficial ownership
  - Financial statements (form differs between Tier 1 & 2)
- Offering statements must be filed on EDGAR
Non-Public Review

• Issuer may subject offering statement to SEC for non-public review
• Offering statement must be filed publicly not less than 21 days before qualification
Offering Communications

• Generally flexible
• Must file solicitation materials with SEC
• After an offering circular is filed, solicitation materials must include a link to the offering circular or a copy
• Solicitation materials must include legends
On-going reporting

• Tier 1
  – Essentially none
  – Exit reports (after termination or completion)

• Tier 2
  – Annual reports (business and operations past 3 yrs)
  – Semi-annual reports (scaled back 10-Q)
  – Current reports (notice of material changes or events)
  – Exit reports (after termination or completion)
Factors to consider

• Timing. We don’t know how long SEC review will take; old Regulation A took months

• Manage Costs. “Test the waters” before incurring filing costs

• Reporting obligations. Tier 2 reporting

• Who are your investors? You can reach anyone with an internet connection

• Will SEC challenge typical real estate fees?

• Affiliate sales limits.

• Secured or unsecured?
Some opportunities . . .

• Companies that can’t or don’t want to rely on “friends and family” for initial equity
• Mini-RE fund with a well-defined market strategy
• Small- to medium-sized land entitlement deals
• Projects where investors can provide market information, political support, and patronage
• Another way to exit after holding an asset?
Why use Regulation A+?

• Regulation A+ strengths
  – Can solicit an unlimited number of non-accredited investors
  – No restrictions on the resale of securities
  – General solicitation and general advertising allowed
  – Mini-IPO possible

• Rule 506 of Regulation D strengths
  – No limit on fundraising
  – No limit on number of “accredited investors”
  – General solicitation and general advertising allowed in some cases
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Real Estate Private Placement Offerings Under Regulation D Rule 506

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Dickinson Wright PLLC
Phoenix, Arizona
Private Offerings are BIG Business

In 2012, the Commission received 18,187 initial filings for offerings under Regulation D, of which 17,203 (approximately 95%) claimed a Rule 506 exemption.

Staff of the Commission’s Division of Economic and Risk Analysis estimates that, for 2009, 2010, 2011 and 2012, approximately $607 billion, $1.003 trillion, $850 billion and $899 billion, respectively, was raised in transactions claiming the Rule 506 exemption.
Private Offerings are BIG Business (cont.)

Private offerings can range from under a million dollars to well over a billion dollars.

Regardless of size of offering, principles are essentially the same.
“Traditional” Rule 506 (now 506(b))

Sales to no more than 35 non-accredited investors

Unlimited number of accredited investors

No “general solicitation.” I.e., no advertising, no targeted mail, no seminars, no web solicitations, etc.

Issuer (and its management) was supposed to have a “pre-existing substantive relationship” with each offeree.
“Traditional” Rule 506 (now 506(b)) (cont.)

If even one non-accredited investor was solicited, certain SEC-mandated disclosure was required: audited financials being the most significant.

Additionally, non-accredited investors either alone or with purchaser representative supposed to meet “knowledge and experience requirement” to evaluate investment (or the issuer reasonably believes that issuer comes within this description)
“Traditional” Rule 506 (now 506(b)) (Cont.)

Many practitioners recommended staying away from making offers to non-accredited investors.

In accredited-investor-only offering, SEC did not mandate specific disclosure. Rather, disclosure of all “material” information: information that a reasonable investor would deem to be of importance in “overall mix” of information received.

SEC rules assumed that “rich people are smart,” i.e., that accredited investors have the sophistication and power to obtain and analyze information.
New Rule 506(c), Courtesy of JOBS Act

Congress evidently believed that removing the ban on general solicitation of accredited investors would “jumpstart” capital formation.

Issuer can make general solicitation without regard to whether recipients/audience are accredited or not— but only sales to accredited investors are permitted under Rule 506(c).

Can use all types of media, including social media.
How Are General Solicitations Made?

Virtually any form: traditional methods such as newspaper advertisements, seminars, direct mail.

Also, internet advertising and social media.
A new industry is developing: internet platforms which make information about private placements to potential investors.

See, e.g., thefundingplatform.com:

“The Funding Platform combines technology and human expertise to assist private issuers and placement agencies to promote Reg. D 506c private placement offerings. The Funding Platform as a whole, acts as a third party advertising agency on behalf of private issuers and placement agents. Our service is designed to take advantage of the recently enacted JOBS Act. The Funding Platform seamlessly enables users to conduct a capital raise much more efficiently, while taking advantage of the elimination of the prohibition against general solicitation and general advertising.

Our agency strength lies in our ability to reach targeted affinity groups via a proprietary multichannel Internet marketing engine we have developed and perfected over the last 10 years.

Driving qualified traffic to your deal is what we do best. There is a wide range of possible marketing and advertising combinations to finely target and qualify the audience that is most interested in your offering.”
Purchasers: Accredited Investors Only

- **Sales** under Rule 506(c) may be made ONLY to accredited investors.
- Under 506(b), issuer simply has to have a “reasonable basis to believe” an investor was accredited. Investor representations as to his/her own accredited status sufficient.
- “Check the box.”
- Worked ok with “pre-existing relationship” required for 506(b).
“Reasonable Steps to Verify”

An issuer may use general solicitation and general advertising in a securities offering that satisfies the other applicable requirements of Reg D if the issuer takes reasonable steps to verify that all of the purchasers are accredited investors.

How?
“Reasonable Steps to Verify” (cont.)

If investor claims accredited status based on *INCOME* test ($200k/$300k), issuer reviews Form W-2s, K-1s, 1099’s, etc. *FOR TWO MOST RECENT YEARS.*

If claiming status based on *NET WORTH* test ($1,000,000 exclusive of primary residence), review bank and brokerage statements, appraisal reports, tax assessments, etc. And to find “net” worth, need to analyze liabilities as well.
“Reasonable Steps to Verify” (cont.)

• Issuer can obtain written confirmation from (i) broker-dealer, (ii) investment adviser, (iii) licensed attorney, (iv) CPA. List is non-exclusive.

• Rapid develop of new industry: “accredited investor verification” services (e.g. “Crowdentials.com,” “crowdcapitalservices.com”). Investors submit information to those platforms, which then verify and certify to issuer that prospective investor has met the requirements.
New “Bad Actor” Rules

Before the JOBS Act, Rule 506 did not contain “bad actor” provisions (although at the very least disclosure of bad acts should have been made even pre-JOBS Act)

Other Rules providing exemptions from registration DID contain “bad actor” provisions.

• “Bad actor” disqualification requirements, sometimes called “bad boy” provisions, disqualify securities offerings from reliance on exemptions if the issuer or other relevant persons (such as underwriters, placement agents and the directors, officers and significant shareholders of the issuer) have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws.

• “Bad acts” include the following (506(d)):
  – securities-related felonies and misdemeanors (10-year lookback)
  – Injunction (five-year lookback) against securities-related (mis)conduct
  – Suspension of B-D license or membership on securities exchange
Bad Actor Rules (cont.)

• Rule re Bad Actors applies to any 506 offerings, both (b) and (c)

• Applies by its terms only to convictions, orders, suspensions, etc. from and after September 23, 2013.

• Also required to disclose “prior ‘bad actor’ events.” Those occurring prior to 9/23/13. Failure to disclose can result in loss of exemption
Issuers Can Use Either 506(b) or 506(c)

Bad actor rules apply to both. But 506(b) may be better for traditional real estate deal, where developer might well have his/her “stable of investors;” friends and family who have invested before.

No intrusive income/net worth verification requirements.

For younger, newer, possibly more tech-savvy developers and potential investors, however, 506(c) may be the only realistic way to access capital for real estate projects.

Enables investors to “get in on deals” otherwise not available.

Intrusive inquiry of income/net worth status may not be objectionable to Facebook/Snapchat generation.
Quick Note on Pre-Emption of State Authority

Rule 506 offerings, both (b) and (c) offerings, are “covered securities” under federal law. Therefore, state regulatory authority over such offerings is pre-empted (except for Form D requirements and anti-fraud authority).
Broker-Dealer Regulation of Rule 506 Offerings

“Traditional” Regulation
- Basic rule

• General rule: Section 15(a)(1) of the Exchange Act requires the registration with the Securities and Exchange Commission (“SEC” or the “Commission”) of any person that acts as a “broker” or “dealer” in securities in interstate commerce. Under Section 3(a)(4)(A) of the Exchange Act, a “broker” is defined generally to mean “any person engaged in the business of effecting transactions in securities for others.”
Again, look for an exemption

“Issuer Exemption” – employees and agents of issuer can make sales of issuer’s own securities, subject to limitations

Rule 3(a)(4)-1 under 1934 Exchange Act

• Summary of Exemption:

  • An associated person of an issuer of securities shall not be deemed to be a broker solely by reason of his participation in the sale of the securities of such issuer if the associated person:

    – Is not a “bad actor;”
    – Receives no commission-based or other sales-based remuneration; and
    – The associated person meets all of the following conditions:

    • The associated person primarily performs, or is intended primarily to perform at the end of the offering, substantial duties for or on behalf of the issuer otherwise than in connection with transactions in securities; and

    • The associated person was not a broker or dealer, or an associated person of a broker or dealer, within the preceding 12 months; and

    • The associated person does not participate in selling an offering of securities for any issuer more than once every 12 months other than in reliance on paragraph (a)4(i) or (a)4(iii) of this section, except that for securities issued pursuant to rule 415 under the Securities Act of 1933, the 12 months shall begin with the last sale of any security included within one rule 415 registration.

• Note: “Associated person” = officer, partner, director, employee of issuer or affiliate of issuer.
Importance of Exemption

• Enables the issuer to sell its own securities (LLC interests, stock, debt securities) without using a broker and without paying fees to brokers.

• For developers and others, may be only practical way to sell securities.
The JOBS Act’s Additional Exemptions

• Congress recognized that “general solicitations” can involve internet advertising, social media, etc., as well as traditional media.

• Demand exists for funding platforms – to advertise and disperse information about securities offerings.

• Need to make sure sponsors of such platforms would NOT be considered brokers.
The JOBS Act’s Additional Exemptions  Cont’d

• JOBS Act provides that person maintaining a platform permitting general solicitations, advertisements, and other sales activities involving securities will not be considered a broker if following are met:
  – No sales-based compensation
  – Person maintaining platform does not hold customer funds
  – Person maintaining platform is not a “bad actor.”

• N.B. STATE regulation of broker-dealers is not pre-empted by this section of the JOBS Act.
Current and Emerging Issues
Opportunities