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REITs and REIT Offerings

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Agenda

- Advantages associated with REITs
- Formation and organization of REITs
- Tax requirements for REITs
- Other regulatory advantages associated with REITs
- Market opportunities for REITs

REIT advantages

Background

- Cigar Excise Tax Extension Act of 1960—Public Law 86-779
- REIT designed to be a mutual fund for real estate
- Flow through taxation
- Passive real estate investing (but this can be very active)

Key Advantages

- No corporate level tax
- Most states follow the federal treatment
- IRS Form 1099 for shareholders
- Non-REIT qualifying activities can be housed in a “taxable REIT subsidiary” or TRS
- REITs can be externally managed or internally managed
- Tax-Exempt Investors
  - Most tax-exempt entities are subject to federal income tax on their unrelated business taxable income (“UBTI”) and, consequently, wish to minimize UBTI.
  - The use of debt financing will generally give rise to UBTI (although certain “qualified organizations” may be eligible for an exception), as will active income from “trade or business” activities.
  - Because a REIT is treated as a corporation for tax purposes, it will generally “block” UBTI from passing through to tax-exempt shareholders as UBTI.

Key Advantages *(cont'd)*

- Non-U.S. Investors
  - Non-U.S. persons are required to file U.S. tax returns and pay tax at U.S. rates if they recognize income that is "effectively connected" with a U.S. trade or business ("ECI"). Consequently, most non-U.S. investors wish to minimize ECI when investing.
  - Active income from "trade or business" activities in the U.S. (which may include rental income) will give rise to ECI.
  - Under the Foreign Investment in Real Property Tax Act ("FIRPTA"), a non-U.S. person's gain from the disposition of a U.S. real property interest is treated as ECI.
    - Qualified foreign pension funds are not subject to FIRPTA
  - Because a REIT is treated as a corporation for tax purposes, it "blocks" most ECI from passing through to non-US shareholders as ECI. However, REIT distributions that are attributable to gain from the disposition of a U.S. real property interest are treated as ECI under FIRPTA (except for a qualified foreign pension fund).

REIT Formation and Organization

How to form a REIT

- Companies owning or financing real estate must meet a number of organizational, operational, distribution and compliance requirements to qualify as a real estate investment trust
- Must be formed in one of the 50 states or the District of Columbia as an entity taxable for federal purposes as a corporation
- Must be governed by directors or trustees and its shares must be transferable.
- To ensure compliance with ownership tests, most REITs include percentage ownership limitations in their organizational documents.

Private REITs

- Private REITs are real estate funds or companies that are exempt from SEC registration and whose shares do not trade on national stock exchanges
- Private REITs generally can be sold only to institutional investors
- Private REITs issue shares that are neither traded on national exchanges nor registered with the SEC, but rather issued pursuant to one or more of several exemptions to the securities laws set forth in regulations promulgated and enforced by the SEC.
  - Such as Section 4(a)(2) permitting an issuer to sell securities to "accredited investors" and Rule 144A, which exempts securities issued to qualified institutional buyers (QIBs).

Private REITs *(cont'd)*

- "Accredited Investors" generally defined as individuals with a net worth of at least $1 million (excluding primary residence) or with income exceeding $200,000 over two prior two years ($300,000 with a spouse)
  - *Will discuss changes to the AI definition in later slides*
- Private REIT shares are generally illiquid. Redemption programs for shares vary by company and may be limited, non-existent, and/or subject to change
- Typically externally advised and managed
- Exempt from SEC registration and related disclosure requirements

Regulation A

- In lieu of the traditional REIT IPO, Regulation A offerings have become an increasingly important capital-raising tool for REITs.
- Regulation A is an exemption from registration for public offerings with two offering tiers: Tier 1, for offerings of up to $20 million in a 12-month period; and Tier 2, for offerings of up to $50 million in a 12-month period.
- For the three years since effectiveness of the amendments to Regulation A in 2015, 257 offerings were qualified and nearly $1.3 billion was raised in Regulation A offerings.
  - Real estate and REIT offerings account for the largest percentage of these transactions.

Forward Sale Arrangements

- REITs also increasingly opted to use forward sale arrangements in order to raise capital due to uncertainty relating to increased market volatility.
- Forward sales allow REITs to sell their shares in the future at a specified price, less a discount, by entering into a forward sale agreement with a forward purchaser as part of the REIT's follow-on offering.
- The forward purchaser borrows shares from the market in order to allow the affiliated underwriter to sell the REIT's shares in the follow-on offering.

1940 Act Testing

- A REIT conducts its business so that it does not come within the definition of “investment company” by ensuring that less than 40% of the value of the REIT’s total assets (less U.S. government securities and cash items) consists of “investment securities” on an unconsolidated basis (referred to as the 40% test).
- Direct and indirect subsidiaries of the REIT may rely upon certain exclusions from registration, including Section 3(c)(5)(C) of the 1940 Act.
- Section 3(c)(5)(C), as interpreted by the Staff of the SEC, requires an entity to invest at least 55% of its assets in real properties and mortgages and other liens on and interests in real estate (“qualifying real estate interests”) and at least 80% of its assets in qualifying real estate interests plus “real estate-related assets.”

1940 Act Testing *(cont'd)*

- In satisfying the 55% requirement, REITs may treat securities issued with respect to an underlying pool of mortgage loans in which it holds all of the certificates issued by the pool as qualifying real estate interests.
  - Real estate-related assets include agency partial pool certificates and credit risk transfer securities
- An asset that can be viewed as the functional equivalent of, and that provides the holder with the same economic experience as, an actual interest in real estate or a loan fully secured by real estate may be treated as a "qualifying interest."
  - REIT should be subject to the benefits (payments on the mortgage loans) as well as the risks (prepayments and defaults) of the mortgage loans

1940 Act Testing *(cont'd)*

- Majority-owned entities may instead rely upon the exemption pursuant to Section 3(c)(1) or 3(c)(7) of the 1940 Act. However, the securities issued by any such entity, together with any other investment securities the REIT may otherwise own, may not have a value in excess of 40%.
- REITs should conduct 1940 Act testing on a quarterly basis and document compliance with an officer's certificate detailing the asset ownership of each entity on an unconsolidated basis and noting the applicable 1940 Act exemption for each entity.

Recent Interpretation

- On February 12, 2018, the SEC staff issued a no-action letter favorable to mortgage industry participants who originate or acquire whole mortgage loans and then securitize them.
- The Staff permitted a mortgage REIT subsidiary to rely on Section 3(c)(5)(C) to the extent that it acquired assets integral to a vertically integrated real-estate finance business, even though it itself did not purchase "mortgages and other liens on and interests in real estate."
- The Staff avoided applying an overly formalistic asset analysis and instead focused on the entity's business activities to determine whether it is primarily engaged in the real estate finance business, and therefore should be able to rely on the Section 3(c)(5)(C) exclusion.

Recent Interpretation *(cont'd)*

- On August 15, 2019, the SEC staff issued a no-action letter to Redwood Trust (a mortgage REIT).
- The Staff concluded that there would be no objection to Redwood treating certain mortgage servicing rights (MSRs) and cash proceeds in the manner described below for the Section 3(c)(5)(C) exclusion
  - MSRs created when mortgage loans are sold or securitized can be treated as "qualifying interests" under Section 3(c)(5)(C)
  - Cash proceeds from mortgage payments and payoffs in connection with real estate-related assets, as well as from the sale of such assets, can retain the characterization of the assets from which the cash proceeds were derived for purposes of Section 3(c)(5)(C), subject to certain time limitations

Recent Interpretation *(cont'd)*

- Redwood also obtained a no-action letter in 2017 relating to the treatment of credit risk transfer securities as "real estate-type interests" under Section 3(c)(5)(C)
- Credit risk transfer securities share similar characteristics with, and have the same economic substance as, agency partial pool certificates, which are treated as "real estate-type interests" under Section 3(c)(5)(C)
- Staff recognized the similarities between credit risk transfer securities and agency partial pool certificates and concluded that the credit risk transfer securities described could be treated as "real estate-type interests"

Further Guidance

- The SEC staff signals that it would like to provide further guidance on the following matters if a request is submitted:
  - Requests to treat as "qualifying interests" certain other mortgage-related assets if they are acquired by an issuer as a direct result of the issuer being engaged in the business of purchasing or otherwise acquiring whole mortgage loans
  - Requests that would broaden the "primarily engagement" test to include other factors that would indicate whether the issuer is primarily engaged in the real estate finance business

Rule 3a-2: Transient Investment Companies

- Transient investment company (for foot faults)
  - When an issuer inadvertently becomes an investment company, it may be eligible to rely on the transient investment company exception – Rule 3a-2
    - Must have *bona fide* intent to be engaged primarily, as soon as reasonably practical (must be at least prior to the termination of the one-year period), in a business of other than that of investing, reinvesting, owning, holding, or trading in securities
    - Issuer can only rely on Rule 3a-2 once during any three year period
    - Intent evidenced by:
      - Looking at business activities
      - Resolution from board of directors
    - One year relief begins the earlier of:
      - The date the issuer owns securities and/or cash having a value exceeding 50% of total assets; or
      - The date the issuer owns or proposes to acquire investment securities having a value exceeding 40% of total assets
    - Not available to an issuer that holds itself out as an investment company

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REIT Tax Requirements

Basic Principles

- General Principles
  - A REIT is taxed as a corporation.
  - However, unlike a regular corporation, a REIT may take a deduction against its gross income for dividends it pays to its shareholders.
  - Thus, REITs generally try to pay dividends in an amount that reduces taxable income to zero.
- Consequences of REIT Disqualification
  - If a REIT is disqualified, it will be taxed as a corporation for U.S. federal income tax purposes at rates up to 21%.
  - However, failure to meet any of the requirements discussed below should not be fatal. In general, such failures can be cured without losing REIT status.

Basic Requirements for REIT Status

- A REIT must be managed by a board of directors or trustees, or equivalent.
- A REIT's share or equity interests must be freely transferable.
- A REIT must have at least 100 shareholders for 335 days of each taxable year.
  - No attribution rules apply
  - An individual, corporation, partnership or a fund, for example, each count as one shareholder
  - Various options to meet this requirement
  - Compliance is waived for the REIT's first taxable year

Basic Requirements for REIT Status

- A REIT may not be closely held – No more than 50% of a REIT's equity interests may be held by five or fewer "individuals" during the last half of a taxable year.
  - Attribution rules apply
  - An "individual" includes a natural person or certain tax-exempt organizations (e.g., private foundations)
  - Compliance is waived for the REIT's first taxable year

Basic Requirements for REIT Status *(cont'd)*

- A REIT must distribute at least 90% of its taxable income annually in the form of shareholder dividends.
  - As a practical matter, a REIT should make distributions totaling at least 100% of its taxable income to avoid entity-level tax.
  - For non-publicly offered REITs dividends must be paid on a pro rata basis within each class and in a manner consistent with the rights and preferences of each class, or they may be considered "preferential dividends" that do not give rise to a deduction and do not count toward the 90% distribution requirement.

Asset Tests

- A REIT must comply with two assets tests at the close of each quarter of its taxable year:
  - the 75% Asset Test; and
  - the 25% Asset Test
- The assets in the 25% "basket" are themselves subject to three limitations: (**i**) the 5% test, (**ii**) the 10% test, and (**iii**) the 25% test (each described below).
- There is a 30-day cure period after the quarter, if needed.
- For purposes of the Asset Tests, where a REIT invests in an entity treated as a partnership, the REIT is treated as owning a proportionate share of the entity's assets.

Asset Tests *(cont'd)*

- 75% Asset Test
  - At least 75% of the value of a REIT's total gross assets must consist of (among other things):
    - Interests in real property;
    - Interests in mortgages/loans secured by real property. Special rules apply to:
      - mezzanine loans secured by a pledge in the property-owning entity; and
      - loans acquired in the secondary market.
    - Shares in other REITs;
    - Cash and cash items (including receivables);
    - Government securities; and
    - Qualified temporary investments of new capital.

Asset Tests *(cont'd)*

- 25% Asset Test
  - The remaining 25% of a REIT's assets generally may be invested without restriction, subject to three additional tests:
  - 5% Test: Not more than 5% of the value of a REIT's total assets (other than those qualifying for purposes of the 75% Asset Test) may be represented by securities of any single non-government issuer (other than a qualified REIT subsidiary ("QRS"), a taxable REIT Subsidiary ("TRS"), or another REIT);
  - 10% Test: A REIT may not own securities (other than those qualifying for purposes of the 75% Asset Test) representing more than 10% of either the vote or value of the outstanding securities of any issuer (other than another REIT, a TRS or a QRS):
    - This test is based on the value of the issuer, something the REIT has no control over;
    - "Straight debt" is excluded in determining compliance with the 10% Value Test; and
    - For example, an issue with the 10% Value Test could arise if the REIT made a loan to a partner in a joint venture.

Asset Tests *(cont'd)*

  - 20% Test: Not more than 20% of the value of the REIT's total assets may be represented by securities of one or more TRSs.

- The 10% Value Test (in detail)
  - As previously noted, a REIT is prohibited from owning securities representing more than 10% of the value of the outstanding securities of any one issuer. This test is based on the value of the issuer, something a REIT has no control over.
  - For purposes of the 10% Value Test, a REIT's interest in a partnership is not a security.
    - Instead, the REIT is deemed to own its proportionate share of each asset of the partnership for purposes of determining a REIT partner's share of partnership securities.
    - Debt issued by the partnership to the REIT (that is not otherwise excluded, as discussed in the immediately following slide) generally is not considered to be a security to the extent of the REIT's interest as a partner in the partnership, or if at least 75% of the partnership's gross income qualifies under the 75% gross income test (discussed later).

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Asset Tests *(cont'd)*

- The 10% Value Test (in detail) *(cont.)*
  - Other items that are excluded from the definition of "securities" for purposes of the 10% Value Test (but not the 5% Asset Test) include the following:
    - Any loan to an individual or an estate;
    - Any obligation to pay rents from real property;
    - Any security issued by a State or political subdivision thereof, the District of Columbia, a foreign government, or any political subdivision thereof, or the Commonwealth of Puerto Rico, but only if the determination of any payment received or accrued under such security does not depend in whole or in part on profits; and
    - Any security issued by a REIT.

Asset Tests *(cont'd)*

- The 10% Value Test (in detail) *(cont.)*
  - "Straight Debt" is excluded in determining compliance with the 10% Value Test (but not the 5% Asset Test).
  - "Straight Debt" is debt where:
    - The debt is evidenced by a written unconditional promise to pay a sum certain in money on demand or on a specified date;
    - The interest rate (and interest rate payment dates) are not contingent on profits, the borrower's discretion, the payment of dividends with respect to common stock or similar factors; and
    - There is no convertibility into stock.

Asset Tests *(cont'd)*

- Any interest or principal will not be treated as failing to satisfy the "Straight Debt" provisions solely by reason of the fact that payment of such principal or interest is subject to a contingency, but only if one of several factors applies (including contingencies that (**i**) do not materially change the effective yield to maturity of the security or (**ii**) occur upon default or the exercise of a prepayment right by the issuer of the debt, provided that it is consistent with customary commercial practice).

Income Tests

- There are two separate percentage tests relating to the sources of a REIT's gross income that must be satisfied for each taxable year:
  - The 75% Gross Income Test
  - The 95% Gross Income Test
- For purposes of the Income Tests, where a REIT invests in an entity treated as a partnership, the REIT is treated as earning a proportionate share of the entity's income.

Income Tests *(cont'd)*

- 75% Gross Income Test
  - On an annual basis, at least 75% of a REIT's gross income must consist solely of:
    - Rents from real property, with certain exceptions;
    - Interest on obligations secured by mortgages;
    - Dividends from, and gains from the sale of, shares of REIT stock;
    - Abatements and refunds of real property taxes;
    - Income from the operation of, and gain from the sale of, "foreclosure property";
    - Amounts received as consideration for agreeing to make mortgage loans (e.g., commitment fees); this does not include processing fees, which are in exchange for services;
    - Certain qualified temporary investment income from investment of new capital; and
    - Gain from the sale of any other real estate asset that is not a "prohibited transaction."

Income Tests *(cont'd)*

- 95% Gross Income Test
  - On an annual basis, at least 95% of a REIT's gross income must be derived from:
    - Income qualifying for the 75% Gross Income Test;
    - Dividends;
    - Interest; and
    - Gains from the sale or disposition of stock or other securities that is not a "prohibited transaction."
  - In other words, a REIT may receive up to 5% of its annual gross income from sources that do not qualify for either the 75% or the 95% Gross Income Tests.

Income Tests *(cont'd)*

- Common Income Test Issues – Equity Investments
  - Tenant Services:
    - A REIT may directly provide services that are not primarily for the convenience of a tenant or that are customarily provided in connection with rental of space for occupancy only (e.g., heat, electricity, common area maintenance, trash collection).
    - Other services that are primarily for the convenience of a tenant must be provided through an independent contractor or a TRS.
    - Services that are not customarily provided in the same geographic market in buildings of a similar class (e.g., maid service, concierge service, valet parking, food service) must be provided by an independent contractor who bears the cost of providing those services and is separately compensated for them, or by a TRS.
    - If services described in the second or third bullet point above are provided other than in the manner described in those bullet points, the gross income attributable to such services (which will not be less than 150% of the REIT's direct cost of providing such services) will not be qualifying income. And if such gross income exceeds 1% of the REIT's gross income from the property, then none of the gross income from the property will be qualifying income.

Income Tests *(cont'd)*

- Common Income Test Issues – Equity Investments *(cont.)*
  - Rents Attributable to Personal Property: A REIT may not enter into a lease where more than 15% of the rent is attributable to the rental of personal property (e.g., furnishings, appliances, equipment, pallet racks). If the rent attributable to personal property exceeds 15% of the total rent for the lease for a taxable year, then all of the rent attributable to the personal property is disqualified.
  - Rents Based on Net Income: A REIT may not receive rents based on net income derived by any person from the property. Rents based on a percentage of gross receipts are permissible.
  - Related Party Rents: A REIT generally may not enter into a lease with a tenant that is more than 10% owned by (**i**) the REIT or (**ii**) a person who owns more than 10% of the REIT. Attribution rules apply when determining ownership for this purpose. However, a REIT may enter into a lease with a TRS if the lease is made on commercial terms and at least 90% of leased space in the property is leased to unrelated parties (a special exception allows hotels and health care properties to be leased 100% to a TRS, as discussed later).
  - Corporate Housing: A REIT generally may not provide "corporate housing" or "hospitality suites" unless the services and furnishings are provided by an independent contractor or a TRS.

Income Tests *(cont'd)*

- Common Income Test Issues – Equity Investments *(cont.)*
  - Marketing of Services: A REIT generally may not market the services of any third party in exchange for payment. However, there are certain exceptions.
  - A REIT may receive a fixed fee or a percentage of gross revenue collected at a property by independent providers of telecommunications services:
  - In exchange for giving telecommunication providers access to the REIT's tenants and passively marketing the telecommunication providers' services to its tenants; or
  - In exchange for granting the exclusive right to a telecommunication provider to market and sell telephone services at the property.
  - A REIT may also provide certain marketing services for its tenants at retail properties by coordinating the marketing efforts related to the property, including preparing and sending brochures and coordinating advertising.

Income Tests *(cont'd)*

- Common Income Test Issues – Equity Investments *(cont.)*
  - Parking Facilities:
    - A REIT may operate a parking facility located in or adjacent to a building occupied by tenants of the REIT so long as the REIT provides no services other than maintaining, repairing, and lighting the parking facility, and other than services provided by a TRS or an independent contractor.
    - If parking spaces are reserved for use by particular tenants at some of the REIT's parking facilities, any recurring functions unique to the reserved spaces (such as enforcement) must be provided by a TRS or an independent contractor from whom the REIT does not receive any income.
    - If spaces are available for use by the general public, the parking facility must be an appropriate size for the building such that the REIT reasonably expects the parking facility to be predominantly used by the building tenants and their guests, customers, and subtenants. Any additional services must be provided by a TRS or an independent contractor.
    - Alternatively, a REIT may lease an entire parking facility to an operator pursuant to a "true lease."
  - Short-Term Leases: A REIT generally may not enter into short-term leases (how short?)

Income Tests *(cont'd)*

- Common Income Test Issues – Debt Investments
  - Shared Appreciation Mortgages: Amounts received pursuant to a loan in which the lender shares in a percentage of the borrower's gain upon a sale of the property securing the loan, or a percentage of the appreciation in such property's value as of a specific date, is treated as gain from the sale of such property, which is generally qualifying income for purposes of the 75% Gross Income Test (unless the underlying property would be "dealer property" in the hands of the REIT). For example, a shared appreciation provision in a condominium project would be problematic.

Income Tests *(cont'd)*

- Original Issue Discount and Market Discount Loans: Income recognized with respect to original issue discount and market discount is generally treated as qualifying interest income for the 95% Gross Income Test and possibly for the 75% Gross Income Test, depending on the nature of the underlying interest.
  - Common Income Test Issues – Debt Investments *(cont.)*
    - Participating Loans/Equity Kickers: Interest will not qualify under either Income Test where the interest is based on the borrower's net income/profits (but interest based on the borrower's gross income is permissible).
  - Undersecured Mortgage Loans:
    - Interest will not qualify for the 75% Gross Income Test (but will qualify for the 95% Gross Income Test) to the extent attributable to a portion of a loan not secured by real property.
    - Interest on loans secured by both real property and other property is apportioned between the portion secured by real property and the portion secured by other property.
  - Mezzanine Loans: Loans secured by pledges of interests in the underlying property owner (rather than mortgages) are subject to special rules (pursuant to Revenue Procedure 2003-65, a safe harbor). For example, a mezzanine loan will fall outside of the safe harbor and may not constitute a good REIT asset if it a recourse loan or is guaranteed on a full recourse basis.

REIT Taxes

- A REIT will pay tax in the following ways:
  - Normal corporate tax (21%) on undistributed taxable income and income from foreclosure property.
  - The 4% excise tax if REIT does not distribute at least 85% of its ordinary income.
  - Penalty tax on amount by which REIT fails to pass either 75% or 95% Income Tests.
  - 100% penalty tax on gains from prohibited transactions (as described in more detail below).
  - 100% penalty tax to the extent that the REIT is not operating on an arm's-length basis with a TRS
- What Is a Prohibited Transaction?
  - A "prohibited transaction" is a sale or other disposition of property that is treated as (**a**) stock in trade of a taxpayer, (**b**) property of a kind that would properly be included in the inventory of the taxpayer, or (**c**) property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business (together, "dealer property"), which is not foreclosure property.
  - A REIT is subject to a 100% tax on any gain from a prohibited transaction.

REIT Taxes *(cont'd)*

- The Prohibited Transaction Safe Harbor
  - A sale of real property will not be treated as a prohibited transaction if all of the following tests are met:
    - 2-Year Rule: The REIT has held the property for at least 2 years for the production of rental income.
      - The holding period for a property that is developed by the REIT begins on the date that the property is placed in service.
    - 30% Test: Aggregate expenditures made by the REIT, or any partner of the REIT, during the prior two years which are includible in property basis do not exceed 30% of the net sales price of the property;
    - No more than 7 sales or 10% of aggregate bases or FMV of REIT assets: During the taxable year (other than foreclosure sales or sales pursuant to condemnation), (a) the REIT does not make more than 7 sales of property or (b) the aggregate adjusted bases of properties sold during the taxable year does not exceed 10% of the aggregate bases of all the assets of the REIT as of the beginning of the taxable year (or up to 20% of the aggregate bases in a year if the trailing 3-year average does not exceed 10%) or (c) the aggregate FMV of properties sold during the taxable year does not exceed 10% of the aggregate FMV of all the assets of the REIT as of the beginning of the taxable year (or up to 20% of the aggregate FMV in a year if the trailing 3-year average does not exceed 10%); and

REIT Taxes *(cont'd)*

- The Prohibited Transaction Safe Harbor *(cont.)*
  - Marketing and development expenditures: If the REIT has more than 7 sales, substantially all of the marketing and development expenditures with respect to the sales property were made through an independent contractor (as defined under the REIT rules) from whom the REIT does not derive or receive income or a TRS.

REIT Taxes *(cont'd)*

- What if the Safe Harbor Does Not Apply?
  - The courts and the IRS have generally applied a facts and circumstances test in determining whether property is dealer property (if the safe harbor does not apply).
  - Facts and Circumstances:
    - Number, frequency and continuity of sales.
    - Purpose for acquisition and reason for which property is held.
    - Length of ownership.
    - Development activities.
    - Sales efforts and/or use of brokers.
  - ***Note***: Ensure that internal investment memoranda, email communications and deal documentation reflect an investment (i.e., non-dealer) intent.

REIT Taxes *(cont'd)*

- Sale of Unwanted Plots of Land (and Other Dealer Property)
  - Certain unwanted plots of land may be acquired as part of an asset acquisition. If the intent is for such unwanted plots to be flipped in a short period of time ("dealer property"), a REIT may be subject to the 100% prohibited transactions tax on any gains derived from the sale of such plots of land (or other dealer properties) because they could be viewed as held for sale rather than for investment.
  - Such sales would also count toward 7-sales or 10%/20% of portfolio limitations of the safe harbor described above, which could impact the ability of other REIT sales to meet the safe harbor.
  - However, a REIT could hold an interest in dealer properties (e.g., unwanted plots of land) through a TRS. The sales of those properties by the TRS would not be subject to the 100% prohibited transactions tax and would not count as REIT sales for purposes of the safe harbor. The TRS would pay corporate tax on any income from such sales. Care should be taken to ensure that the TRS (and not the REIT) is treated as the seller for federal income tax purposes.

Regulatory Developments

Key Performance Indicators

- On January 30, 2020, the SEC provided guidance regarding the disclosure of key performance indicators and metrics used in the MD&A section.
  - Similar to earlier concerns raised by the SEC with respect to the use of non-GAAP financial measures.
- The SEC's Division of Enforcement has taken action in recent years against companies relating to the use of misleading key performance metrics.
- Item 303(a) of Regulation S-K requires discussion of "such other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations." In addition, Instruction 1 to Item 303(a) requires discussion of "statistical data that the registrant believes will enhance a reader's understanding of its financial condition, changes in financial condition, and results of operations."

Key Performance Indicators *(cont'd)*

- Guidance reminds each registrant that uses metrics in its MD&A that, under existing requirements, it "need[s] to include such further material information, if any, as may be necessary in order to make the presentation of the metric, in light of the circumstances under which it is presented, not misleading.
- SEC generally expects that a metric be accompanied by the following disclosure:
  - A clear definition of the metric and how it is calculated;
  - A statement indicating the reasons why the metric provides useful information to investors; and
  - A statement indicating how management uses the metric in managing or monitoring the performance of the business.

Key Performance Indicators *(cont'd)*

- If a company changes the calculation method or presentation of a metric from one period to another or otherwise, it should consider disclosing, to the extent material:
  - The differences in the way the metric is calculated or presented compared to prior periods;
  - The reasons for the change;
  - The effects of the change on the amounts or other information being disclosed or previously reported; and
  - Other differences in methodology and results that would reasonably be expected to be relevant to an understanding of the company's performance or prospects.
- Depending on significance, it may be necessary to recast prior metrics to conform to the current presentation following a change in methodology.

COVID-related Non-GAAP Measures

- When you take a defined GAAP measure and either exclude items that are components or include items that aren't components, the result is a non-GAAP financial measure.
- In late March 2020, SEC Staff at the Division of Corporation Finance issued CF Disclosure Guidance: Topic No. 9, *Coronavirus (COVID-19)* ("Topic 9 Guidance"), in which they frowned upon companies giving way to any pandemic-driven pressure to "present … non-GAAP financial measures or metrics for the sole purpose of presenting a more favorable view of the company."
- Instead, the SEC Staff encouraged companies to share "why management finds the measure or metric useful and how it helps investors assess the impact of COVID-19 on the company's financial position and results of operations."

NYSE proposed changes to stockholder approval rules

- On December 16, 2020, the NYSE filed a proposed rule change to certain of its shareholder approval requirements
- Last year, the NYSE temporarily waived certain requirements under Section 312 as a result of the COVID-19 pandemic.
  - The NYSE has proposed to extend these temporary waivers through March 31, 2021 (proposal is currently subject to public comment).
- The NYSE's proposed rule change includes permanent amendments that are identical to last year's temporary waivers.
- On February 12, 2021, the SEC designated April 4, 2021 as the date by which the SEC will approve or disapprove of the proposed rule changes.

NYSE proposed changes to stockholder approval rules *(cont'd)*

- Section 312.03(b) requires shareholder approval for certain issuances of common stock to specified related parties.
  - Approval is required if the shares to be issued exceed 1% of the shares outstanding before the issuance.
  - Limited exception permits sales to related parties that are only substantial security holders of the issuer so long as no more than 5% of outstanding shares are issued and the shares are issued at no less than the minimum price.
- The NYSE proposes to amend this rule to limit the class of related parties that would trigger the requirement to obtain shareholder approval.
- Would no longer require shareholder approval for issuances of more than 5% of outstanding shares to a related party so long as issued at a minimum price

NYSE proposed changes to stockholder approval rules *(cont'd)*

- Section 312.03(c) requires shareholder approval of any issuance of 20% or more of outstanding shares before such issuance, excluding (**i**) any public offering; or (**ii**) any bona fide private financing (defined as no one purchaser acquiring more than 5% of outstanding shares) that complies with the minimum price requirement.
- The NYSE proposes to replace the reference to "bona fide private financing" with "other financing in which the company is selling securities for cash."
- Effectively would eliminate the 5% limit for any single purchaser but retain the minimum price requirement.

Amending the "Accredited Investor" Definition

- On August 26, 2020, the SEC adopted amendments to the definition of "accredited investor" and related amendments to the definition of "qualified institutional buyer."
- The adopting release reaffirms the existing aspects of the definition that an accredited investor includes a person who meets one of the listed qualification methods.
- The amendments supplement the existing definition by adding two new categories of accredited investors for natural persons, regardless of such person's income or net worth.

New Categories for Natural Persons

- The first added category allows a natural person to qualify as an accredited investor, regardless of net income or net worth, if the person holds certain professional certifications, designations or credentials
- The second added category allows knowledgeable employees to qualify as accredited investors for purposes of investing in the funds sponsored by their employers.
- The final amendments clarify that, in calculating income and net worth, as well as in the context of knowledgeable employee joint investments, an investor can aggregate the investor's income or net worth, as the case may be, with that of his or her spouse or spousal equivalent.

New Categories for Institutions

- The amendments also add several new categories of entities to the accredited investor definition, including:
  - SEC- and state-registered investment advisers
  - Rural business investment companies
  - Limited liability companies (or any similar business entity) that satisfy the other requirements of the definition of "accredited investor" (i.e., total assets in excess of $5 million and not formed for the specific purpose of acquiring the securities being offered)
  - Any entity that does not otherwise qualify as an accredited investor owning investments as defined in Rule 2a51-1(b) under the Investment Company Act in excess of $5 million that is not formed for the specific purpose of acquiring the securities being offered
  - Any family office with at least $5 million in assets under management

Qualified Institutional Buyer Definition

- The SEC also amended the definition of qualified institutional buyer in Rule 144A to avoid inconsistencies and include the entities that qualify as institutional accredited investors when these entities meet the $100 million in securities owned and invested threshold in Rule 144A.

Expanded Ability to Engage in Test the Waters Communications

- On September 26, 2019, the SEC extended the ability to test the waters to all issuers by adopting new Rule 163B. Prior to Rule 163B, the ability to test the waters was limited to EGCs.
- Testing the waters communications may solicit nonbinding indications of interest but may not solicit a binding commitment or customer order.
- Testing the waters communications can be oral or written and may occur either prior to or following the date of filing of a registration statement.
- Testing the waters activities vary from deal to deal. Typically, in a capital markets transaction, they resemble a roadshow presentation where management meets with potential investors and gives a presentation describing the issuer and the proposed offering.

Expanded Ability to Engage in Test the Waters Communications *(cont'd)*

- Under Rule 163B, any issuer, or person authorized to act on behalf of the issuer (including an underwriter), may engage in exempt oral or written communications with potential investors that are, or are reasonably believed to be, qualified institutional buyers ("QIBs") or institutional accredited investors ("IAIs") to determine whether such investors might have an interest in a contemplated registered securities offering.
  - <u>**QIB definition**</u>: Any institutional investor that qualifies as an accredited investor under Rule 501 of Regulation D under the Securities Act of 1933 (the "Securities Act"), acting for its own account or the accounts of other QIBs, that owns and invests on a discretionary basis at least $100 million in securities of unaffiliated issuers. Banks and certain other specified financial institutions must also have a net worth of at least $25 million. A registered broker-dealer is a QIB when it owns and invests on a discretionary basis at least $10 million in securities.
  - <u>**IAI definition**</u>: Any institutional investor that qualifies as an accredited investor under Rule 501 of Regulation D under the Securities Act (generally an entity with total assets in excess of $5 million).

Expanded Ability to Engage in Test the Waters Communications *(cont'd)*

- The SEC staff typically requests, in connection with its review of a registration statement, that any testing the waters communication used in connection with an offering be furnished to the staff for review.
- Rule 163B requires only a reasonable belief (no specific steps are required) that the investors receiving communications are QIBs or IAIs rather than requiring that such investors in fact fall into those categories.
  - Approach is intended to provide issuers with the flexibility to use methods that are cost-effective but appropriate in light of the facts and circumstances of each contemplated offering and each potential investor.
  - Issuer must take reasonable steps to prevent testing the waters communications from being shared with non-QIBs and non-IAIs.

Regulation FD

- Regulation FD requires public companies to publically disclose any material nonpublic information ("MNPI") that has been selectively disclosed to certain securities market professionals or shareholders.
- If companies or underwriters rely on Rule 163B, they must ensure compliance with Regulation FD by requiring investors to enter into a confidentiality undertaking and agree not to trade in the company's securities prior to public disclosure or abandonment of the offering (wall crossing).
- If MNPI is provided to investors, the company may be required to publicly disclose such information in order to release those investors from the terms of the confidentiality agreement and trading restriction.
  - Cleansing disclosures will not be required if the only MNPI shared with investors is the fact that the issuer is contemplating an offering.

Non-exclusive integration safe harbors

New Rule 152(b) provides the four non-exclusive integration safe harbors shown below:

Safe Harbor 1, Rule 152(b)(1)	Any offering made more than 30 calendar days before the commencement of any other offering, or more than 30 calendar days after the termination or completion of any other offering, would not be integrated with such other offering; provided, that, for an exempt offering for which general solicitation is not permitted that follows by 30 calendar days or more an offering that allows general solicitation, the provisions of Rule 152(a)(1) apply (i.e., the purchasers either were not solicited through the use of general solicitation or established a substantive relationship with the issuer prior to the commencement of the offering for which general solicitation is not permitted).
Safe Harbor 2, Rule 152(b)(2)	Offers and sales made in compliance with Rule 701, pursuant to an employee benefits plan, or in compliance with Regulation S would not be integrated with other offerings.
Safe Harbor 3, Rule 152(b)(3)	An offering for which a Securities Act registration statement has been filed would not be integrated if made subsequent to: (**1**) a terminated or completed offering for which general solicitation is not permitted; (**2**) a terminated or completed offering for which general solicitation is permitted and made only to qualified institutional buyers (QIBs) and institutional accredited investors (IAIs), or (**3**) an offering for which general solicitation is permitted that terminated or completed more than 30 calendar days prior to the commencement of the registered offering.
Safe Harbor 4, Rule 152(b)(4)	Offers and sales made in reliance on an exemption for which general solicitation is permitted would not be integrated if made subsequent to any terminated or completed offering.

Market Opportunities

What are the limits on the types of businesses a REIT can own/operate?

Historical Equity REIT Asset Classes

- Residential Apartments
- Shopping Centers
- Commercial Office Buildings

Additional Equity REIT Asset Classes

- Lodging
- Self Storage
- Real Estate Spinoffs from Operating Companies
- Timber
- Healthcare
- Distribution Centers

Newest Equity REIT Asset Classes

- Gaming Properties
- Outdoor Advertising
- Cell Towers
- Data Storage Centers
- Farmland

Supplemental Materials

- *On Point. Real Estate Investment Trusts*

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