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# Real Estate Investment Fund Private Placements: Structuring Securities Offerings After the JOBS Act

Leveraging New Solicitation and Advertising Avenues  
and Navigating Stricter Rule 506 Safe Harbor Provisions

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THURSDAY, JULY 17, 2014

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Today's faculty features:

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**Arizona State University**, Tempe, Ariz.

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# “Real Estate Investment Fund Private Placements: Structuring Securities Offerings After the JOBS Act”

By: David I. Thompson

Dickinson Wright PLLC, Phoenix

and

Mark Stapp

Arizona State University, Tempe

# Introductions

# How Private Placement Has Worked

# Trends in Raising Money



# Some Context on Banking

# Everything takes capital

- Nothing happens without capital
- Capital includes debt and equity
- Because most projects require a lot of capital there is a need for debt;

**This is where the problem begins!**

# Real Estate lending

- Up until early 1980's local banks and S&L's did most of the lending for real estate projects – was a local asset funded with mostly local debt;
- Real estate is a local asset supporting local life.

**But lending is no longer a local function!**

# Problem is long time in the making

- Growth in 1980's fueled by banks, foreign investors and insurance companies – but mostly S&L's;
- Fed put “hold”/ban on real estate lending 1990-92 which limited construction;
- Very little was known about the real estate industry – was not one of the investment asset classes (cash, stocks and bonds).

# Reaction to “ban”

- Recapitalizing was needed but Fed looked for more oversight on real estate;
- This was taken up by Wall Street investment banking firms – long term source of corporate capital AND traders of publicly-traded financial markets – these guys already had a process and regulatory system;

# Implementation

- Major problem is that real estate is an illiquid asset class and was owned in small pieces (one building, one owner);
- This was solved by dusting off an old instrument – REITS --so assets could be bundled, sold on a daily basis as liquid asset;
- This provided liquidity for real estate ownership.

# A new problem begins to take shape

- Wall Street had taken up the trading of secondary residential mortgage business in late 1980's – fueled residential expansion;
- Wall Street started binge on REIT formations and offerings in 1993;
- This idea was then applied to commercial mortgage backed-securities (CMBS) bonds – a way to bundle mortgages on commercial projects.

# One issue – core problem

- Each piece of real estate is unique;
- Public markets have a precondition to deal with “like for like” assets - do not like to trade unique things – too hard to value and understand;
- CMBS and REITS allowed Wall Street commoditize real estate;
- Wall Street and Fed regulations favor big scale projects (trade/borrow a lot to cover all the costs).



# Commoditizing Real Estate

- Wall Street and commercial banks who sell their loans and/or syndicate them so need to standardize to simplify;
- Result is defining real estate into 19 “standard product types”;
- Easy for residential because instruments are all similar (deeds of trust, promissory notes, etc) – much harder for commercial because all instruments are different.

# Who establishes the criteria?



- Investors want product to invest in

- Investment bankers want lots of product they can easily underwrite (very high cost of transactions)

- Banks want to sell loans to investment bankers to get them off books so need to comply with their underwriting criteria

- Borrowers need to comply with bank requirements
- Borrowers need to find projects that can be underwritten.

# What happened

- This means real estate companies had to commoditize what they built – what was in demand was suburban growth products (lots of them, big and understandable) – it became auto oriented development;
- Major categories include big box retail, entry level housing, known named occupants;
- The real estate is no longer the underwriting focus-- it became mostly the credit.

# Result

- **No longer locally financed;**
- Simple to build, stand alone, easy to underwrite was financeable - standardize;
- Real estate development strategy became “same product, different market”;
- Development companies became commoditized;
- Lots of cash flowed into real estate so it was added to other asset classes.

# Result

- Lenders need scale – project size and money (expensive to do these deals);
- Lenders need comfort – big names give them “sameness” and so comfort when real estate is unique;
- They think short term – after initial funding decision making is different;
- Focused on the “Prudent man rule” – do only what others are doing its safer.

# Changing nature of Real Estate

- **Popular culture** is driving “urban” life (Seinfeld, Sex in the City) as a good way to live;
- **Anti-growth** sentiment (sprawl is bad);
- **Rise of “New Urbanism”** as a design focus;
- **Downtown redevelopment** is a focus and major cities are cleaning up and redeveloping;
- **Consumer research** shows 30 – 40% of all households want walk-able, mixed use development;
- **Concern for the climate** – sustainability movement

# New Direction

- Old strategy was commoditized product focused;
- New focus is “place based/focused”;
- Creating meaningful, lifestyle and life supporting projects that are distinctive and sought after.
- This requires a very close connection to local markets.

# New Problem

- Major finance systems and criteria have not changed, making it very hard to finance new development concepts – underwriting local tenants is hard and financial markets don't like unique – too hard to trade;
- Very expensive and time consuming – need policy changes and lots of local support;
- Downtown, local projects are small scale – our current systems do not favor and too hard to achieve critical mass.



# What's needed

- *How do you invest in your community? How do you have an association with and stake in the outcome?*
- Alignment of interests;
- Balanced approach;
- A community investment equity fund that is for local, small scale, local merchant focused projects;
- Local underwriting, local decision making;
- Fed rules and tax treatment that favors all equity and “REITS” for individual buildings.

# FINANCING

Getting the Capital You Need to Get Started and Operate

*“We haven’t the money so we’ve got to think”*

Lord Rutherford

# Changes in Raising Private Funds

# Crowd Source Funding

Looking to the public for capital

# What is Crowdsourcing?

An open call

A way to obtain needed services, ideas, funds, feedback or content by soliciting contributions from a large group of people (typically online), rather than from traditional employees, investors or suppliers.



Traditional banking not providing needed funds or terms and conditions are too burdensome so alternative sources are emerging.

# Use of collective intelligence and shared values

# Can be used for various needs

Problem-solving

Production

Voting

Supplies, or

Capital

What is “Crowd Source Funding”?

# Crowd Source Funding

Some people have ideas for products, services, support.

Some people are looking to support ideas, products and services

Crowd Source Funding Connects these Groups

We think of *Kickstarter* and *Indegogo* but there are others

Kickstarter

IndieGoGo

spot.us

33needs

Profounder

Microplace

Crowdrise

Firstgiving

DonorsChoose

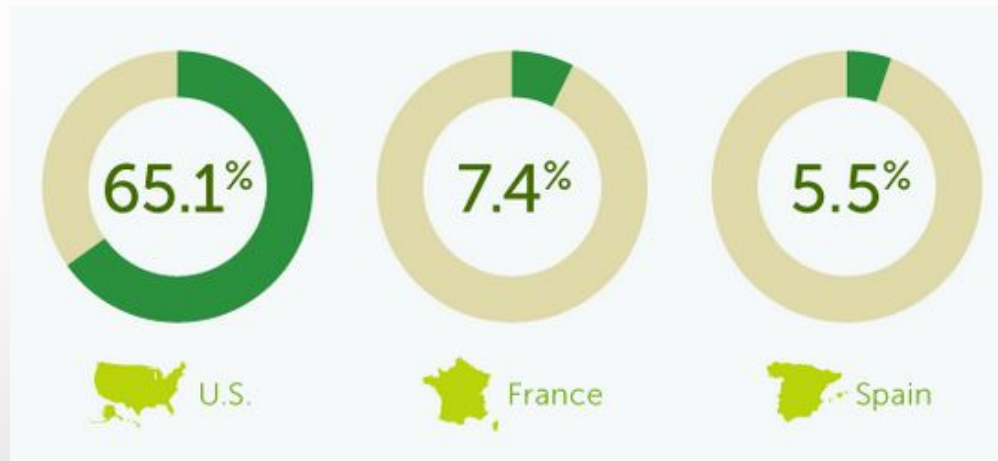
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Fundable

# Some Facts About Crowd Source Financing



# Where are most requests worldwide



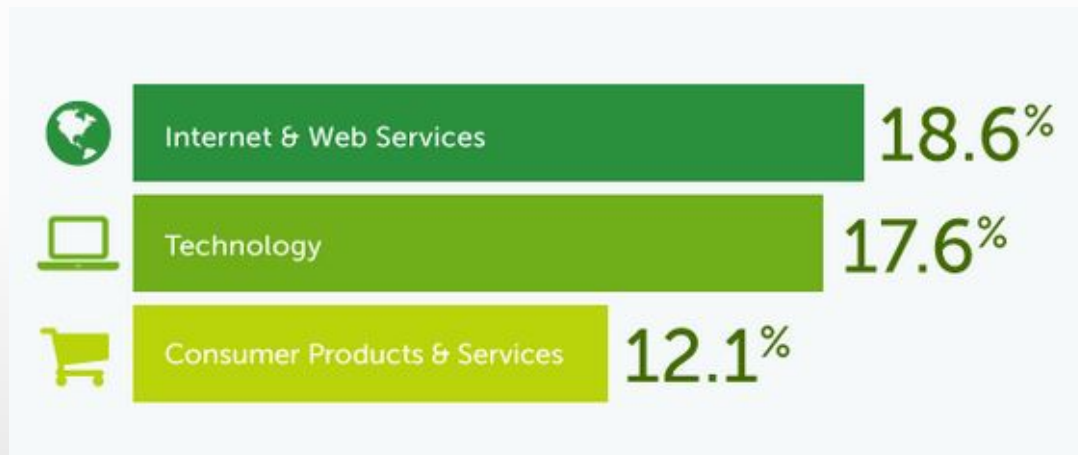
Source: Gust

# Where are most requests made in US



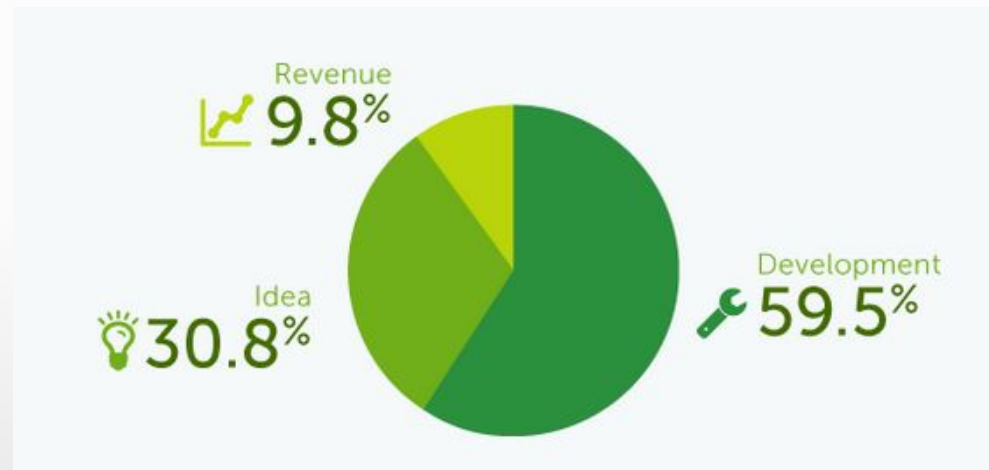
Source: Gust

# What type of companies are getting funded



Source: Gust

# What stage in the growth process are funding being applied



Source: Gust

44% of projects reached their funding goals

Most successful projects raise less than \$10,000

Number of projects that have raised \$1 million or more:

56

Currently pledged projects:

**\$959 million**



Percent of projects that have finished without a single pledge:

**10%**

Percentage of projects that raised more than 20%  
of their goal and ended up successfully funded:

**80%**

# gust

Investor portal that connects startups with  
accredited investors

[www.gust.com](http://www.gust.com)

# Patch of Land

Example of how crowd sourcing is moving into real estate equity realm.

“Patch of Land pre-funds the deals that you are investing in; we are the only real estate crowdfunding platform that has skin in the game.”

Crowd funding is not an easy way to raise money. There are no guarantees: success depends on many factors but being prepared and having the right presentation is critical (have a great story and be able to tell it passionately and succinctly).

# Promotion is vital

Your business can't just rely on the pitch that is on whichever crowd funding site your company is using. Your business still needs to have a complete and comprehensive promotional campaign to generate interest in your crowd funding pitch.

# Multiple investments

Crowd funding is just one way to potentially finance your business' project. Often, a number of investment systems will need to be used to gain the level of investment your business needs. Don't rely solely on crowd sourcing to fund your project.

April 2012 President Obama signed “Jumpstart Our Business Startups (“JOBS”)” Act



# Startups (“JOBS”)" Act

Designed to streamline process through which start-up and small business could raise funds by selling equity capital and soliciting small investments over the internet.

# Real Estate Investment Fund Private Placements: Structuring Securities Offerings After the JOBS Act

David I. Thompson  
Dickinson Wright PLLC  
Phoenix, Arizona

## A few brief introductory points

“JOBS Act” = “Jumpstart Our Business Startups” Act. Pushed by Republicans but adopted with bi-partisan support and signed by President Obama in early 2012

JOBS Act (i) authorized crowdfunding as a recognized part of the securities offering toolkit; (ii) provided a new exemption to registration for certain small companies; (iii) provided relief to “emerging growth companies” from certain SEC filing requirements; and (iv) permitted offerings under Rule 506 to be made via general solicitation.

# 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))

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.

# How Are General Solicitations Made? (cont.)

A New industry is developing: internet platforms which make information about private placements to potential investors.

See, e.g., [thefundingplatform.com](http://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

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- **Sales** under Rule 506(c) may be made ONLY to accredited investors.
- Under 506(b), issuer simply had 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. “Crowdentals.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.)

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- 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***;
  - 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

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- 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

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- 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 Exemption

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- 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