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DO THE SECURITIES LAWS APPLY TO SMALL REAL ESTATE DEALS?

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Two friends identify an attractive commercial real estate investment. They'll form a limited liability company (LLC) for the investment and both invest. They'll also raise more capital from friends and family, a great opportunity for all concerned. Before the two friends go out and find investors, though, they should think about the federal Securities Act of 1933 (the "Securities Act") and state securities laws ("Blue-Sky Laws").

These laws can apply whenever deal sponsors bring investors, even just a few, into a typical real estate deal, because the investors will purchase equity interests in the entity that undertakes the investment. Those equity interests almost certainly constitute "securities" as a legal matter. So a typical real estate deal structure involves a sale of securities that is prima facie subject to the Securities Act and Blue-Sky Laws.

As a starting point, all sales of securities must: (i) either be registered with the federal Securities and Exchange Commission (the SEC) or qualify for an exemption from registration; and (ii) comply with the Blue-Sky Laws of each state where offered and sold. Typically that means the states where the actual or potential issuer or seller of securities (an "Issuer")[1] and investors reside.

In particular, two important federal exemptions from registration could apply: (i) Securities Act Section 4(a)(2)[2] and (ii) the related "safe harbor" under SEC Rule 506(b), part of Regulation D issued by the SEC under authority of the Securities Act (Reg. D).

The sponsors also must consider filings that may be required under the securities statute of New York State (NYS). That statute is Article 23-A of the NYS General Business Law, also known as the Martin Act, and often referred to as the New York Blue-Sky Laws (NYS Blue-Sky Laws).[3] Specifically, General Business Law § 352-e requires registration of certain real estate syndication offerings.[4]

FEDERAL SECURITIES ACT

The Securities Act[5] has two basic objectives: (i) assuring that investors receive financial and other significant information on securities being offered for public sale; and (ii) prohibiting any deceit, misrepresentation, or fraud in the sale of securities.[6] Securities Act Section 2(a)(1) defines a "security" very broadly to mean:

> [a]ny note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral

rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.[7]

This definition captures a huge range of investments. Even so, it is not exhaustive. Something could still be a "security" even if not specifically listed in the definition.[8] The United States Supreme Court has declared that the definition is "quite broad."[9] And Congress intended that the definition would capture "the many types of instruments that, in our commercial world, fall within the ordinary concept of a security."[10] As a result, the courts would almost certainly treat a limited liability company interest or membership interest in a real estate investment LLC as a "security," even though the statutory definition of "security" does not specifically list either.

EXEMPTION UNDER FEDERAL SECURITIES ACT

Securities Act Section 4(a)(2)

This exemption under the Securities Act applies when an Issuer sells or issues securities (or proposes to do that) in a way that does not involve a public offering (a "Private Placement"). It exempts a Private Placement from the registration and robust disclosure requirements of the Securities Act.

Under this exemption, no SEC filings are required, but the statute is unclear on which particular securities offerings actually constitute Private Placements so are exempt. Judicial and regulatory interpretations have looked at a handful of "factors," which must be considered case by case. No single factor is determinative on its own. These factors are:[11]

- Number of offerees and preexisting relationship between Issuer and each offeree. No specific maximum number[12] of offerees disqualifies a transaction from this exemption. In general, the more offerees, the harder it is to claim exemption as a Private Placement. **This factor is critical.**
- Number of securities offered and size of offering. The smaller the number, the less likely the offering will be deemed a public offering.
- Manner of offering. The offering should be made through Issuer's direct communications with eligible offerees.[13] It should not involve any general advertising or general solicitation. This means, for example, that the sponsors of the hypothetical real estate investment described above may approach their family and friends to invest, but those family and friends should not approach their family and friends – two degrees of separation.
- Sophistication and experience of offerees. General business knowledge and experience usually suffice to satisfy this factor for exemption. Other considerations include education, occupation, business and investment experience, and net worth. An investor with a sophisticated representative probably (but not always) satisfies this factor for exemption. Alternatives to sophistication include financial ability to bear risks (i.e., the investor's wealth) and existence of a special relationship with Issuer (i.e., insider or personal relationship).[14]
- Nature and kind of information given (or available) to offerees. The disclosure need not be as extensive as in an SEC registered offering. It should, however, be factually sufficient. Before any sale, Issuer should fully disclose all material information about the investment and the LLC.
- Issuer's measures to prevent resales. The immediate investors should agree to hold the securities and not resell them. Premature resale of securities may be deemed a public distribution and considered part of the original offering. Issuers should take reasonable measures to prevent resale of securities they issue. They should at least: (i) obtain each investor's written representation that it acquires the securities for

investment and not with a view to distribution; (ii) place restrictive legends on any certificates evidencing the securities;[15] (iii) prohibit transfers except to a narrow group of family members and affiliates; and (iv) issue stop transfer orders for the securities.

Because the six factors listed above are flexible and hence unpredictable, an Issuer will never have absolute certainty on whether an offering constitutes an exempt Private Placement, even if the Issuer can legitimately check the box for every factor listed. The Issuer bears the burden of showing that the Private Placement exemption applies. If it does not apply and no other exemption applies, then the Issuer will be deemed to have conducted an unregistered public offering, potentially creating liability under federal securities laws.

In response to this uncertainty, the SEC adopted Reg. D to give Issuers a "safe harbor" to conduct limited Private Placements.

Rule 506(b) of Reg. D

Rule 506(b) of SEC Reg. D establishes exemption standards that are more objective.[16] Issuers conducting an offering under Rule 506(b) can raise unlimited proceeds and sell securities to an unlimited number of accredited investors. Reg. D defines "accredited investor" to include (for our purposes) certain high net worth individuals and individuals with income above a threshold, i.e., people with enough business knowledge and experience to evaluate the risks of the prospective investment. Issuer cannot, however, engage in solicitation or advertising to market the securities and must not sell securities to more than 35 non-accredited investors.

Just as the SEC requires for Private Placement offerings, an Issuer that relies on Rule 506(b) should disclose all material information on the offering. If the Issuer targets even just one non-accredited investor, though, Reg. D requires additional specific and more cumbersome disclosures, including: (i) disclosure documents generally consistent with those for registered offerings (e.g., a Private Placement Memorandum or Confidential Information Memorandum); (ii) audited financial statements specified in Rule 506; and (iii) answering questions from prospective purchasers that are non-accredited investors.[17]

Any Issuer relying on Rule 506(b) would be well-advised to deal only with accredited investors and make no solicitations at all to non-accredited investors. In other words, although Reg. D allows up to 35 non-accredited investors, any cautious Issuer should replace "35" with "zero." In addition to having to spend more time and money to satisfy extra disclosure requirements, Issuers that sell to non-accredited investors need to recognize that those investors, as a practical matter, more likely cannot bear the risk of loss of their investment. They will more likely make repeated inquiries on the status of their investment. And they will more likely find a lawyer and file suit if the deal fails because, e.g., they lost their life savings or money they needed to live on.

If Issuer does in fact sell securities to non-accredited investors, the fewer non-accredited investors the better. Issuer should not rely on the fact that Rule 506(b) technically allows Issuer to sell to 35 non-accredited investors. That scope of permitted sales does not eliminate the problems that arise by selling to non-accredited investors.

Rule 506(c) of Reg. D

Rule 506(c) allows Issuer to broadly solicit and advertise an offering and still qualify for exemption if: (i) every investor is an accredited investor; and (ii) Issuer takes reasonable steps to verify that status (e.g., reviewing prospective investors' Forms W-2, tax returns, and bank statements) and does not merely take the investors' word for it.

Form D Filing

To qualify for exemption under Rule 506, Issuer must file a Form D electronically with the SEC within 15 days after the first sale of securities. This is a strict and very short time limit. Rule 506 defines the first sale as the date when the first investor irrevocably contractually commits to invest.[18] That could happen long before the closing.

Form D requires the names and addresses of the Issuer's promoters, executive officers, and directors; the offering amount; and some other details on the offering. It requires almost no other information. Although this may seem like a relatively simple form, Issuers often need more time than expected to gather all the required information and still meet the strict 15-day deadline.

Before an Issuer files a Form D,[19] it must first file an SEC Form ID.[20] This too is a fairly straightforward process but also takes time. This sequential form-filing exercise gives Issuer another reason to plan ahead to avoid problems meeting the SEC's 15-day deadline.

Any Form D filed by any Issuer will be disclosed in the SEC's public EDGAR database.[21] For privately held companies, though, the information that can be obtained from EDGAR is quite limited. It includes the name of Issuer (or the name of the filer if not Issuer), mailing address, email address, and telephone number, and a contact person for questions about filing (both an SEC account contact and an EDGAR contact). EDGAR should not include any confidential information about the Issuer or the offering.

If the Private Placement exemption under Section 4(a)(2) doesn't apply and the Issuer fails to file a timely Form D, the Issuer may face severe consequences. It may be found to have engaged in the unlicensed sale of securities or the sale of unregistered securities. It could face criminal or civil prosecution, fines, or a mandatory rescission. A rescission requires Issuer to refund every dollar raised, effectively requiring Issuer to guaranty all investors against all losses. Issuer may also be enjoined from later relying on the Rule 506 exemption.[22] These penalties could significantly increase Issuer's cost of raising capital for future deals or prevent Issuer from conducting future business altogether.

General Comments

Whether or not an offering is exempt from registration requirements, Issuer should give investors enough information to avoid violating the anti-fraud provisions of the securities laws. Issuer must not give investors false or misleading statements or omit information if that omission makes the information provided false or misleading. If Issuer is unsure (or feels some unease) about whether to share any particular information with prospective investors, that usually means Issuer should share it. The requirements in this paragraph apply regardless of the nature, size, and type of offering or investors.

Finally, although Rule 506 of the Securities Act preempts state registration and qualification laws, any state where an investor resides may require additional notice filings and collect state fees.[23] Not surprisingly, NYS does exactly that.

NYS BLUE-SKY LAWS FILING REQUIREMENTS

Securities filing requirements in NYS are onerous and expensive. Some New York attorneys assert that these filings are not required when an offering qualifies for exemption under SEC Rule 506(b) or Rule 506(c). In 2002, the New York State Bar Association Committee on Securities Regulation issued a position paper making this argument.[24] That position paper was, however, submitted to and never accepted by the NYS Attorney General (NYAG), which is often very aggressive in protecting New York consumers and finding and acting against "abuses." For this reason, an Issuer that wants to play it safe should comply with filing requirements under the NYS Blue Sky Laws in addition to those under the Securities Act.

In contrast to the timing requirements under Securities Act Rule 506, NYS Blue-Sky Laws require an Issuer to make a notification filing (NYS Form 99) before (not after) any sale or offering of securities in NYS.[25]

Issuer must submit these items: (i) two copies of the completed NYS Form 99 (one must be manually signed);[26] (ii) a NYS Notice; (iii) a NYS Further Notice;[27] (iv) if applicable, a form U-2 Consent to Service of Process for an Issuer not incorporated or organized in NYS;[28] (v) a copy of the offering documents (the limited liability company agreement if no subscription agreement exists); and (vi) checks for filing fees.

SHOULD ISSUER FILE?

Small issuers often choose not to file under the Securities Act and NYS Blue-Sky Laws because: (i) they want to prevent deal information from becoming public (even just how much money they raised, since the actual legal documents need not be filed); (ii) they want to avoid filing fees,[29] legal costs,[30] and extra steps; and (iii) as a practical matter, regardless of the legal discussion above, filing under the Securities Act or Blue-Sky Laws is rare in small deals involving only a few (e.g., three) investors who have a pre-existing relationship (business or personal or both) with Issuer.

For deals that involve more than a few investors, filing seems to be somewhat more common, but whether to do so is still not absolutely black and white. As an informal industry practice, Issuers typically do not file for these slightly larger deals with a slightly larger investor group. A more conservative Issuer might file a Form D with the SEC and the required paperwork with NYAG, as an insurance policy to reduce the risk of future problems.

The filings themselves are straightforward, more logistical than legal. But they take time. They create new opportunities for mistakes and future issues. An attorney can handle the federal and state filing(s) or Issuer may decide to file on its own. If an Issuer plans to comply with state Blue-Sky Laws, then whenever Issuer plans to sell to an investor in a new state, Issuer or its attorney must check that new state's filing and other requirements before the investor becomes committed to the deal.

CONCLUSION

Real estate professionals should consider registration and filing requirements under the Securities Act and Blue-Sky Laws before bringing investors into a real estate transaction. This applies to deals large and small, such as the initial example with two friends who might bring in a handful of investors.

Even if a deal involves only a few investors, do not assume the Section 4(a)(2) Private Placement exemption applies. Instead, take a step back and evaluate whether, based on all facts and circumstances and Issuer's risk tolerance, it makes sense to rely on this exemption or to seek additional comfort under the safe harbor of Rule 506(b).

A few take-aways for any Issuer:

- Don't hide material information. Provide full disclosure regardless of deal size.
- Regardless of the legal merits, as a practical matter Issuers of "small deals" often do not worry about the issues in this memo, except the preceding subparagraph.
- The fewer investors, the more likely Issuer can qualify for exemption.
- Stick to accredited investors.
- Stick to people the sponsor knows, not people who those people know.
- When filing under the securities laws, plan ahead and meet the deadlines.

Notes

1 15 U.S. Code § 77b(a)(4)- Definitions; promotion of efficiency, competition, and capital formation, https://www.law.cornell.edu/uscode/text/15/77b.

2 15 U.S. Code § 77d- Exempted transactions, https://www.law.cornell.edu/uscode/text/15/77d.

3 G.B.L. Article 23-A – Fraudulent Practices in Respect to Stocks, Bonds and Other Securities, https://ag.ny.gov/sites/default/files/pdfs/bureaus/investor_protection/library/NY%20Gen%20Bus%20Law%20Article%2023-A.pdf.

4 G.B.L. §352-e, Real Estate syndication offerings, https://codes.findlaw.com/ny/general-business-law/gbs-sect-352-e.html.

5 15 U.S. Code § 77a et seq., https://www.govinfo.gov/content/pkg/COMPS-1884/pdf/COMPS-1884.pdf.

6 See SEC Publication, Fast Answers, The Laws That Govern the Securities Industry, https://www.sec.gov/answers/about-lawsshtml.html#secact1933.

7 15 U.S. Code § 77b(a)(1) – Definitions; promotion of efficiency, competition, and capital formation, https://www.law.cornell.edu/uscode/text/15/77b.

8 The definition of "security" has a catchall for any "instrument commonly known as a security." The cases interpret this to mean Congress intended to include instruments not specifically listed in the definition. The SEC has urged a broad interpretation of the definition to protect investors. Substantial case law has developed over many years on whether particular instruments are "securities."

9 Marine Bank v. Weaver, 455 U.S. 551, 555-556 (1982).

10 H. R. Rep. No. 85, 73d Cong., 1st Sess., 11 (1933); see American Bar Association, What Constitutes a Security and Requirements Relating to the Offer and Sales of Securities and Exemptions From Registration Associated Therewith (April 27, 2017), https://www.americanbar.org/groups/business_law/publications/blt/2017/04/06_loev/.

11 See SEC Release No. 33- 4552, https://www.sec.gov/rules/final/33-4552.htm.

12 Industry practice may suggest that this number is 35 investors. As a legal matter, however, limitation to 35 investors doesn't necessary qualify a deal for the exemption.

13 Though Issuers can technically hire third party "finders" to raise capital in a Private Placement, that is inadvisable, as Issuer loses control and increases the likelihood of overbroad or otherwise illegal marketing activities. More generally, it is just a bad idea to use a broker-dealer (a term with special meaning and implications under the securities laws) or any other intermediary to raise capital in a Private Placement.

14 As a practical matter, Issuer should satisfy itself that no investor is investing money it cannot afford to lose. No investor should invest their life savings or money they require to live on.

15 Preferably, Issuer should not issue certificates at all, as that can facilitate future transfers. If Issuer does issue certificates, they should include conspicuous legends restricting transfer.

16 17 C.F.R. § 230.506 – Exemption for limited offers and sales without regard to dollar amount of offering, https://www.law.cornell.edu/cfr/text/17/230.506.

17 See SEC Publication, Private placements – Rule 506(b), https://www.sec.gov/smallbusiness/exemptofferings/rule506b.

18 If the due date falls on a Saturday, Sunday or holiday, it moves to the next business day. See SEC Publication, Filing and Amending a Form D Notice, A Compliance Guide for Small Entities and Others, http://www.sec.gov/info/smallbus/secg/formdguide.htm.

19 See SEC Publication, Form D, Notice of Exempt Offering of Securities, https://www.sec.gov/about/forms/formd.pdf.

20 See SEC Publication, Division of Corporation Finance Guidance on Form D Filing Process, https://www.sec.gov/corpfin/form-d-filing. The filing page can be found at U.S. Securities and Exchange Commission, Electronic Data Gathering, Analysis, and Retrieval (EDGAR) Filer Management, https://www.filermanagement.edgarfiling.sec.gov/filermgmt/Welcome/EDGARFilerMgmtMain.htm.

21 See SEC Publication, Fast Answers, Regulation D Offerings, https://www.sec.gov/fast-answers/answers-regdhtm.html.

22 17 C.F.R. § 230.507- Disqualifying provision relating to exemptions under §§ 230.504 and 230.506, https://www.law.cornell.edu/cfr/text/17/230.507.

23 See SEC Publication, Private placements – Rule 506(b), https://www.sec.gov/smallbusiness/exemptofferings/rule506b and SEC Publication, Rule 506 of Regulation D, https://www.investor.gov/introduction-investing/investing-basics/glossary/rule-506-regulation-d.

24 The Committee on Securities Regulation of the New York State Bar Association, Private Offering Exemptions and Exclusions Under the New York State Martin Act and Section 18 of the Securities Act of 1933 (2002), https://nysba.org/app/uploads/2020/07/Private-Offering-Exemptions-and-Exclusions.pdf.

25 NYAG recently proposed changes to modify notice filing requirements for private funds offered under Reg. D and require "finders" to register and comply with broker-dealer registration and exam requirements. According to NYAG, the changes would conform New York's regulations to federal securities regulations, including timing requirements for filing. See Press Release, New York State Office of the Attorney General, Attorney General James Moves to Modernize and Streamline Securities Filings in NYS (April 6, 2020), https://ag.ny.gov/press-release/2020/attorney-general-james-moves-modernize-and-streamline-securities-filings-nys.

26 See https://ag.ny.gov/sites/default/files/form99.pdf. Issuer should include a copy of Form D as filed with the SEC. If that has not yet happened, submit a copy of the unfiled Form D and state when filing will occur. When it does, submit an "as filed" copy to NYAG.

27 See New York State Division of Corporations, State Records and Uniform Commercial Code, State Notice/Further State Notice, https://www.dos.ny.gov/forms/corporations/0125-f.pdf.

28 See NYAG Publication, Instructions for Filing a Designation for Service of Process (or Form U-2) Pursuant to Sections 352-a or 352-b of the General Business Law of the State of New York, https://ag.ny.gov/sites/default/files/form-u2.pdf.

29 Form D has no filing fee. For a real estate syndication, the filing fee for NY Form 99 is $1,050, plus $900 if the offering exceeds $500,000.

30 Legal fees should not exceed $5,000.