CROWDFUNDING FOR REAL ESTATE INVESTORS

REGULATION D,
RULE 506(C) VS. REGULATION A +

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OVERVIEW

Crowdfunding is the biggest buzzword in raising capital since the Jumpstart Our Business Startups Act of 2012 (JOBS Act) was enacted. The word crowdfunding has become synonymous with advertising for investors, which under certain provisions of the JOBS Act is allowed. Crowdfunding was permitted prior to the enactment of the JOBS Act, but only for not-for-profit ventures; for-profit companies could not advertise for investors unless they had an approved intrastate offering.

Title II of the JOBS Act directed the Securities and Exchange Commission (SEC) to draft regulations allowing advertising of offerings limited to accredited investors, which resulted in the SEC's adoption of Regulation D, Rule 506(c) in September 2013.

Title IV of the JOBS Act, also referred to as Regulation A+, allows companies to use equity crowdfunding platforms to raise as much as $50M from both accredited and non-accredited investors. Regulation A + is broken up into two tiers, Tier 1 and Tier 2.

This white paper will explore the differences between Rule 506(c) and Regulation A +.

REGULATION D RULE 506(C)

With the adoption of the regulations for Rule 506(c), companies are now allowed to advertise and generally solicit their investment opportunities to the general public. Under Rule 506(c), there is no limit on the amount of capital that a company can raise. A company raising capital can create a website soliciting funds, or it can hold seminars or meetings with potential investors, soliciting investment of funds from those in attendance. This is a significant change to the prior offering rules, which clearly prohibit such activities.

There is one catch: a company raising funds can only accept funds from "accredited investors." An accredited investor is someone with $200K in annual income ($300K if married) or $1M in net worth (excluding equity in home). The verification requirement that all purchasers be accredited investors contrasts with the "old" Rule 506 offering, which remained in Rule 506(b), that allowed up to 35 purchasers to be non-accredited investors if they are capable of evaluating the merits and risks of the potential investment. Companies selling securities going forward must evaluate the trade-off between general solicitation (but being limited to only selling to accredited investors) and selling to up to 35 sophisticated non-accredited investors (but being limited to private offerings that do not involve general solicitation).

When making a 506(c) offering, the company raising capital by issuing the securities must take reasonable steps to verify that each purchaser is an accredited investor. This verification requirement is a new for Rule 506(c) and is always required if an issuer generally solicits and markets to investors. The SEC has set forth four non-exclusive safe harbors that are sufficient, but not necessary, for the company to comply with the verification requirement. The SEC also allows a general principles-based framework in order to determine whether, under the particular facts and circumstances of each case, a company has taken reasonable steps to verify investor status. Any company that fails to meet one of the non-exclusive safe harbors can still rely on the general principles-framework, which determines the reasonableness of the verification based on the surrounding facts and circumstances.

NON-EXCLUSIVE SAFE HARBORS

The SEC has provided the following four non-exclusive safe harbors that companies can rely on to satisfy the verification requirement in Rule 506(c):

1. Analyzing a natural person's US tax documentation to verify income in the past two years, combined with obtaining a written statement of the investor's expectation for income in the current year;
2. Reviewing an investor's consumer credit report and bank and brokerage statements, US credit reports, or real estate appraisals to confirm net worth;

3. Using a third-party registered or licensed professional, such as a securities attorney or certified public accountant to provide written confirmation that the investor is indeed verified as accredited; or
4. For any natural person who invested in a company's Rule 506(b) offering as an accredited investor prior to the effective date of Rule 506(c) and remains an investor of the company, for any 506(c) offering conducted by the same company, the verification requirement in Rule 506(c) is deemed to be satisfied with respect to the investor by obtaining a certificate from the investor at the time of sale under the 506(c) offer that the investor remains an accredited investor.

PRINCIPLE BASED VERIFICATION

Under the general principles-based framework, whether the steps taken to verify investor status are "reasonable" is an objective determination by the company in light of the particular facts and circumstances of each purchaser and transaction.

The factors that the company is to consider are:

1. The nature of the purchaser and the type of accredited investor that the purchaser claims to be;
2. The amount and type of information that the company has about the purchaser; and
3. The nature of the offering, such as how the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.

Under this principles-based framework, there is no set formula for determining whether an issuer took reasonable steps to verify that a purchaser was an accredited investor. The SEC has indicated that the company may rely upon, in addition to other reliable sources, information obtained from publicly available filings with government regulatory bodies, third-party information that is reasonably reliable (such as pay stubs indicating a natural person's income for the last two years) or third parties that are in a position to verify a person's accredited status (such as accountants, securities brokers and attorneys). With respect to the nature of the offering and how the purchaser was solicited, the greater the general solicitation by the company, the greater the measures the company must take to verify accredited status. For example, companies soliciting on a website generally available to the public must take greater measures to verify accredited status than companies soliciting for an offering with a substantial minimum investment on a website available only to a pre-selected group of high-net-worth individuals.

Utilizing the principle-based approach to verify accredited investor status means the company is relying on the judgment of its team. Taking that approach creates the risk that at any point the SEC might determine that the company's judgment was flawed. And if even a single investor has not been properly verified, the company could lose its Rule 506(c) exemption and the consequences could be dire.

REGULATION A+

Regulation A + is divided into two tiers, Tier 1 and Tier 2.

TIER 1

Under Tier 1, a company can raise up to $20 million in any 12-month period. In connection with any offering under Regulation A, all investors must be provided with, or given information to access, an offering circular. For Tier 1 offerings, this offering circular must also be filed with, and is subject to review and qualification by, the SEC, as well as by the securities regulator in the states where the offering is being conducted.

One notable characteristic of a Tier 1 offering is that companies relying on Tier 1 need not obtain an audit and do not have ongoing reporting requirements other than a final report on the status of the offering.

TIER 2

Companies offering securities under Tier 2 can offer up to $75 million in any 12-month period. As with Tier 1, all investors must be provided with, or given information to access, an offering circular. For Tier 2 offerings, the offering circular is subject to review and qualification by the SEC but is not subject to review by state securities regulators.

Companies offering securities under Tier 2 are subject to ongoing reporting requirements. Like public companies that regularly disclose their financial results, companies raising money under Tier 2 must also file regular reports with the SEC. Tier 2 companies are only required to file a semi-annual (Form 1-SA) and annual report (Form 1-K) as well as interim current reports (Form 1-U) upon the occurrence of certain enumerated events.

Securities offered under Tier 2, however, may be listed on a national exchange to the extent that the company applies for listing and meets the listing requirements for that particular exchange. In such circumstances, the company must comply with more extensive ongoing reporting requirements as if it were a public company including, for example, the requirement to file quarterly reports.

ELIGIBLE SECURITIES

Equity, debt and convertible securities (including guarantees of such securities) are eligible for sale under both Tier 1 and 2. The SEC has clarified that all securities, rather than just equity securities, that are convertible or exchangeable into equity interests are eligible, which would expand the scope to include warrants.

ELIGIBLE COMPANIES

Only companies both organized and with their principal place of business in the United States or Canada are eligible to engage in a Regulation A+ offering. A company will be considered to have its "principal place of business" in the United States or Canada for purposes of determining eligibility to use Regulation A+ if its officers, partners or managers primarily direct, control and coordinate the company's activities from inside the United States or Canada.

The following types of companies cannot use Regulation A+ to raise capital:

1. Companies subject to reporting under the Securities Exchange Act of 1934 (Exchange Act), other than voluntary filers;
2. Investment companies and business development companies
3. Blank check companies;
4. Companies subject to bad actor disqualification;
5. Companies with fractional undivided interests in mineral rights;
6. Companies who failed to file ongoing reports required by Regulation A+; and
7. Companies that are, or have been subject to, an SEC order denying, suspending or revoking the registration of a class of securities within five years before the filing of the offering statement.

LIMITATIONS ON SECONDARY SALES

The SEC believed that allowing secondary sales under Regulation A+ was important in providing liquidity to security holders, but it added first-year limits and created different requirements for affiliates and non-affiliates after the first year. Existing security holders can only sell securities totaling 30% of the aggregate offering price of the Regulation A+ offering for the 12-month period following the offering. After the 12-month period, the final rules differentiate between secondary sales by affiliates and by non-affiliates:

Affiliates of the company are limited to selling no more than $6 million of their stake, in the case of Tier 1, or no more than $22.5 million, in the case of Tier 2, over a 12-month period.

Non-affiliates are limited only by the maximum offering amount permitted by either Tier 1 ($20 million) or Tier 2 ($75 million) during any 12-month period; sales by the company and secondary sales by affiliates are aggregated with nonaffiliated secondary sales for these purposes when calculating compliance with the maximum offering amount under Tier 1 or 2

INVESTOR RESTRICTIONS

If relying on Tier 1, there are no limitations on who can invest or how much one can invest. Under Tier 2, unless the offered securities will be listed on a national securities exchange when the offering is qualified, purchasers must be one of the following:

1. Accredited investors; and
2. Non-accredited investors who are subject to investment limits based on the greater of annual income and net worth.

Tier 2 companies are required to inform investors of these investment limitations.

Companies may rely on an investor's representation of compliance with the limitations unless the company knows, at the time of sale, that the representation is untrue.

TESTING THE WATERS

Companies can obtain indications of interest from potential investors, a practice known as "testing the waters." A company using Regulation A can test the waters both before and after filing the offering statement with the SEC. Marketing materials used after the offering statement has been publicly filed with the SEC, must be accompanied by a current preliminary offering circular or contain information on how the most current preliminary offering circular can be obtained. This requirement can be satisfied by providing a website where the preliminary offering statement is available, including the SEC's site, EDGAR.

Companies must include testing the waters materials as an exhibit to the offering statement when it is either first submitted for nonpublic review or first filed (and must update the exhibit with substantive changes in the testing the waters materials after the initial nonpublic submission or filing). Companies and intermediaries using testing the waters materials after the offering statement has been publicly filed with the SEC must update and redistribute the marketing materials. To the extent that the materials themselves or the preliminary offering circular become inaccurate or inadequate in any material respect, the materials must be redistributed in a substantially similar manner to how they were originally distributed.

Regardless of whether a company tests the waters prior to its offering being qualified, the company must deliver a copy of the preliminary offering circular to prospective purchasers at least 48 hours before a sale. Testing the waters marketing materials remain subject to antifraud and other civil liability provisions of federal securities laws.

THE ADVANTAGES OF REGULATION A+ IN RELATION TO RULE 506 ARE AS FOLLOWS:

- Regulation A+ securities are not "restricted securities." Securities purchased in a Rule 506 offering are restricted securities and not freely tradable.
- Regulation A+ securities can be offered to the general public. General solicitation is permitted under Rule 506(c), but sales pursuant to Rule 506(c) can only be made to accredited investors and the company must take reasonable steps to verify the status of purchasers as accredited investors.
- Companies are not required to use reasonable methods to verify accredited investor status for purposes of the investment limitation in Regulation A+ offerings. Unlike Rule 506(c), companies issuing a Regulation A+ offering can rely on purchaser self-certification, unless the company knows that the purchaser's self-certification is wrong.
- There is no limit to the number of non-accredited investors in a Regulation A+ offering. Non-accredited investors are not permitted in Rule 506(c) offerings.

THE ADVANTAGES OF RULE 506 IN RELATION TO REGULATION A+ ARE THE FOLLOWING:

- There are no limitations on the amounts that can be raised. Regulation A+ offerings are subject to the Tier 1 ($20 million) and Tier 2 ceilings ($75 million).
- Rule 506 always preempts state securities registration requirements (other than notice filings and anti-fraud provisions). Tier 1 Regulation A+ offerings remain subject to state securities registration requirements.
- There are no mandatory disclosure provisions if sales are made only to accredited investors. Regulation A+ contains various required disclosures.
- Rule 506 offerings do not involve any review of the offering documents by the SEC. Regulation A+ offering documents must be filed with and are subject to review by the SEC (and state securities regulators in Tier 1 offerings).
- Rule 506 does not require ongoing reporting by the company, unlike the Regulation A+ Tier 2 provisions.

WHY IS THIS IMPORTANT TO REAL ESTATE INVESTORS?

Crowdfunding has re-shaped real estate investing in many significant ways and those changes have been largely positive. For example, crowdfunding regulations have brought increased transparency to real estate investing. With that increased transparency comes perhaps the most significant change: crowdfunding has greatly increased accessibility to the real estate investing marketplace. Crowdfunding has opened up an entirely new asset class to a wider pool of investors (in the case of Regulation A+) by lowering the financial barrier-to-entry. As for real estate companies and operators, Crowdfunding has made it easier and more efficient to access capital —real estate companies and operators are no longer restricted to approaching only investors they know.

Those benefits aside, Regulation A+ is not for the casual real estate company or operator; rather, it is for those real estate companies and operators that are serious about raising money, want to reach a wider audience and plan to be in this business for the long-haul. Regulation A+ could be ideal for seasoned issuers who have already conducted private placement offerings in the past or those companies and operators who are ready to take their real estate investment companies public. Due to the lengthy approval process for a Regulation A+ offering, Regulation A+ will not work for the real estate company or operator who has a property under contract with a set closing date of 60 or 90 days. But Regulation A+ may be an excellent option for private money lenders, serial borrowers, fix and flippers or experienced commercial investors who want to raise money and buy multiple properties under a specified offering, semi-specified offering or "blind pool" scenario.

ABOUT THE AUTHOR

As a results-oriented dealmaker, Jason enjoys creating solutions that bring together great people, projects and capital.

When working on sophisticated business and financing transactions, Jason focuses on the big picture to ascertain his clients' strategic business direction and formulate risk mitigation strategies to protect corporate capital and profitability. His extensive experience includes advising businesses, lenders, investors, startups, and real estate investment companies and developers across the United States, on business transactions from formation to exit, acquisition, due diligence, real estate securities offerings, joint ventures, disposition and financing of real estate.

Passionate about real estate investing, Jason frequently speaks, writes and teaches on the topic, and is also a real estate investor himself. He has authored two books about private money lenders and is working on an eBook focusing on real estate syndication. Jason leads Foster Garvey's Real Estate Funds & Syndications Team.

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