

Notice to Members

MARCH 2005

SUGGESTED ROUTING

Corporate Finance
Internal Audit
Legal & Compliance
Registered Representatives
Retail
Senior Management

KEY TOPICS

Broker-Dealer Registration
Due Diligence
Non-Conventional Investments
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Real Estate
Rule 2420
Suitability

GUIDANCE

Private Placements of Tenants-in-Common Interests

NASD Issues Guidance on Section 1031 Tax-Deferred
Exchanges of Real Property for Certain Tenants-in-
Common Interests in Real Property Offerings

Executive Summary

This *Notice* addresses Section 1031 tax-deferred exchanges of real property for certain tenants-in-common (TIC) interests in real property offerings.¹ In a TIC exchange, interests in real property are exchanged for instruments that generally are securities for purposes of the federal securities laws and NASD rules.² This *Notice* reminds members that when offering TIC interests that are securities to customers, members and their associated persons must comply with all applicable NASD rules, including those addressing:

- ♦ suitability;
- ♦ due diligence;
- ♦ splitting commissions with unregistered individuals or firms;
- ♦ supervision; and
- ♦ recordkeeping.

In addition, members relying on private offering exemptions from the registration requirements of the Securities Act of 1933 must ensure that their manner of offering TIC interests complies with all applicable requirements, including the prohibition on general solicitation.

Questions/Further Information

Questions concerning this *Notice* should be directed to Joseph E. Price, Vice President, Corporate Financing Department, at (240) 386-4623 or Gary L. Goldsholle, Associate Vice President and Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8104.

Characteristics of TIC Exchanges

Tax Status

Typically, the sale of an investment, including an investment in real estate, is a taxable event, with the seller being responsible for capital gains taxes on the appreciation of the investment. Under Section 1031 of the Internal Revenue Code, however, an investor in income-producing or rental real estate may exchange the investment for another investment in income-producing or rental real estate of equal or greater value and defer payment of capital gains. In order to qualify for a deferral under Section 1031, an investor must acquire an interest in real estate in the exchange, not an interest in a partnership.

For example, if an investor purchased rental real property in 1972 for \$50,000, the property today may be worth \$2 million dollars. The sale of the property would cause the seller to incur taxes on the profit. If the owner of the rental property exchanged the rental property for different real property, he could defer paying these taxes. Because of the difficulty of finding equal and offsetting properties for each investor, sponsors have offered interests in larger real estate offerings to pools of investors, in the form of TIC interests. In the example provided, rather than exchanging a rental property valued at \$2 million for a similarly valued property, the owner could pool his interest with other similarly situated property owners to acquire property or properties with a large enough value to provide tax deferral for all the investors. If, however, the pool of investors is treated as a partnership under the principles of federal tax law, the exchange will not qualify under Section 1031, and the taxes on the investors' profits will not be deferred under that section.

TIC exchanges have grown dramatically, from approximately \$150 million in sales in 2001 to approximately \$2 billion in 2004.³ The driving force behind the growth in TIC exchanges is their favorable tax treatment.

In March 2002, the IRS issued Revenue Procedure 2002-22, 1 C.B. 733 ("Rev. Proc. 2002-22"), which addresses the conditions under which the IRS will consider a request for a ruling that a TIC interest in rental real estate is not an interest in a partnership. Rev. Proc. 2002-22 describes the central characteristic of a tenancy in common (each owner is deemed to own individually a physically undivided part of the entire parcel of property) and sets forth 15 specific conditions that must be met before the IRS will consider issuing a ruling.⁴ If the arrangement among the investors is respected as a TIC interest in rental real estate, rather than an interest in a partnership, an exchange may qualify under Section 1031 if the other conditions of that section are satisfied.

Securities Law Status

When TICs are offered and sold together with other arrangements, they generally would constitute investment contracts and thus securities under the federal securities laws.⁵ An investment contract includes any contract, transaction or scheme in which persons invest their money in a common enterprise, with the expectation of profits to be derived predominantly from the efforts of others.⁶ TIC interests are generally investment contracts because the tenants in common invest in an undivided fractional interest in the rental real property by pooling their assets and sharing in the risks and benefits of the enterprise, while obtaining profits derived predominantly from the efforts of others, such as through contracts concerning leasing, management and operation of the acquired property. In addition to managing the property, TIC sponsors typically structure the TIC and negotiate the sale price and the loan. The fact that investors in a particular TIC program might have authority to terminate a management contract, or even to maintain or repair the property, would not demonstrate that the TIC interest is not an investment contract.⁷

Although Section 1031 does not apply to an exchange of investment property for “interests in a partnership,” “stocks, bonds, notes,” or “other securities,” the federal securities law definitions of those terms do not control interpretation of the tax laws. Accordingly, the fact that TIC interests typically are investment contracts under securities laws does not inherently disqualify them as property that may be exchanged under Section 1031.

We have become aware that certain states may exempt particular types of TIC transactions from the definition of “security” under state law. We remind members, however, that a determination that a particular transaction does not involve a security for purposes of state law is not determinative for purposes of federal securities law.

Application of NASD Rules to TIC Exchanges

TIC interests are a type of non-conventional investment (“NCI”). In NTM 03-71, NASD explained that members engaged in the sale of NCIs must ensure that those products are offered and sold in a manner consistent with the member’s general sales conduct obligations, as well as address any special circumstances presented by the sale of those products. Among the issues highlighted in NTM 03-71 are members’ responsibilities to:

- ◆ conduct appropriate due diligence;
- ◆ perform a reasonable-basis suitability analysis;
- ◆ perform customer specific suitability analysis for recommended transactions;
- ◆ ensure that promotional materials used by the member are fair, accurate, and balanced;
- ◆ implement appropriate internal controls; and
- ◆ provide appropriate training to registered persons involved in the sale of these products.

Suitability and Due Diligence

Before recommending a TIC exchange, members must have a clear understanding of the investment goals and current financial status of the investor. In many cases, a TIC interest will constitute a significant portion of an investor's total assets. Because of the favorable tax treatment, investors often elect to invest the entire proceeds from the sale of an investment property in a TIC exchange. Concentration of an investor's assets in a single asset class, however, is not suitable for many investors.⁸ Members must, with respect to each customer for whom they make a recommendation, consider the risks from over-concentration against the benefits of tax deferral and the investment potential of the underlying real estate asset(s).

TIC interests are illiquid securities. NASD is not aware of any secondary market for TIC interests. Moreover, the tenant-in-common form of ownership may require unanimous consent to sell a TIC interest. The subsequent sale of TIC interests may only be possible at a significant discount to the net asset value of the undivided interest in the real estate. As fees charged in connection with a TIC exchange increase, the money saved as a consequence of tax deferral will be offset. Accordingly, members should consider the effect of fees on each TIC exchange.

TIC exchange sponsors routinely obtain legal opinions regarding whether a particular TIC's offering structure will qualify as a like-kind exchange of real property under Section 1031. Given the importance of that tax treatment, a member should obtain a "clean" legal opinion that a TIC "should" or "will" qualify for exchange under Section 1031. If a sponsor failed to obtain a legal opinion, or only obtained a "more likely than not" opinion, that would be a material fact. In such a case, a member, as part of its due diligence responsibilities would be required to ascertain the specific tax status risks of the TIC exchange and inform the investor of the risks involved.

In making a suitability determination in connection with a recommendation to a customer to purchase a TIC interest, a member must also consider whether the fees and expenses associated with TIC transactions outweigh the potential tax benefits to the customer. TICs structured with high up-front fees and expenses paid to the sponsor and/or salespersons of the selling broker-dealers raise particular concerns about the ability to make a suitable recommendation. In addition, TIC transactions in many cases may not provide complete tax-free exchanges for investors (e.g., in situations where the investor's debt ratio on the replacement property decreases, the difference may result in a taxable event for the investor). Members must take all of these factors into consideration when recommending a particular TIC transaction to a customer.

NTM 03-71 reminds members that the type of due diligence that is appropriate will vary from product to product. NASD staff believes that it is not appropriate for members that recommend a TIC transaction simply to rely on representations made by the sponsor in an offering document. While the nature and extent of verification will vary with the facts and circumstances related to particular sponsors and offerings, members should make a reasonable investigation to ensure that the offering document does not contain false or misleading information. Such an investigation could include background checks of the sponsor's principals, review of the agreements (e.g., property

management, purchase and sale, lease and loan agreements) and property inspection.⁹ In addition, if the offering document contains projections, members should understand the basis for those projections, and the degree of likelihood that they will occur. For example, members should determine whether any projected yields can reasonably be supported by the property operations.

Payment of Referral Fees

Real estate agents sometimes refer their customers to broker-dealers that offer TIC exchanges. Moreover, some states may require that a licensed real estate agent participate in the transfer of a TIC interest to an investor. A broker-dealer that pays a fee to the real estate agent or splits its brokerage commissions with the agent in connection with a TIC exchange may be deemed to have violated NASD Rule 2420. This rule generally prohibits the payment of commissions and fees to entities that operate (or based on the proposed activities, would operate) as unregistered broker-dealers. Under Section 3(a)(4)(A) of the Securities Exchange Act of 1934, a “broker” is defined as a person “engaged in the business of effecting transactions in securities for the account of others.” Section 15(a) of the Exchange Act sets forth the general registration requirements for brokers and dealers.¹⁰

The determination of whether an entity should be registered as a broker-dealer rests with the Securities and Exchange Commission. Among the activities the SEC staff has found require registration are:

- ◆ receiving transaction-based compensation;
- ◆ participating in presentations or negotiations;
- ◆ making securities recommendations or discussing or presenting the attributes of a securities investment;
- ◆ structuring securities transactions; and
- ◆ recommending lawyers, underwriters, or broker-dealers for the distribution or marketing of securities in the secondary market.¹¹

It is our understanding that the SEC staff would deem a real estate agent’s receipt of a referral fee from a broker-dealer in connection with the sale of a TIC interest to be the type of activity that would render the real estate agent an unregistered broker-dealer. Therefore, under Rule 2420, a member may not pay a real estate agent who is not registered as a broker-dealer for participating in the transfer of a TIC interest that is structured as a security, nor may a member pay such real estate agent for referring TIC business that involves securities.¹² A member also may not evade Rule 2420 through indirect payments; for example, a member may not engage in an arrangement in which it reduces its normal commission for a TIC exchange so that the customer will pay the difference to the real estate agent for participating in the TIC exchange or for referring business to the broker-dealer.

Members that act as TIC sponsors and pay fees to real estate agents should carefully review SEC and NASD precedent and, if necessary, consult an attorney with experience in these matters.

Licensing, Supervision and Recordkeeping

Associated persons selling TIC interests must have passed the appropriate qualification examinations. Because TICs are typically structured as direct participation programs (“DPPs”), associated persons who sell them generally must have passed either the Series 7 or the Series 22 (Limited Representative — Direct Participation Program securities). In addition, most states require the Series 63 State Agent’s license. Also, as with any security, a TIC interest transaction must be reviewed and endorsed by a qualified principal in accordance with the member’s supervisory procedures.¹³ A qualified principal for supervising TIC interests would be either a General Securities Principal (Series 24) or a DPP principal (Series 39).

In accordance with NASD Rule 3010, members should establish an appropriate supervisory system for the offer and sale of TIC interests. The system should include comprehensive written supervisory procedures reasonably designed to ensure compliance with all applicable rules, including suitability and sales practice requirements related to TIC transactions. The supervisory system should address the sales practice issues discussed in this Notice, including ensuring that neither the member nor its registered representatives pay referral fees or otherwise share transaction-based compensation from TIC transactions with persons that would be deemed to be unregistered broker-dealers.

NASD and SEC record keeping and retention requirements also apply to TIC transactions, and firms should establish appropriate procedures to comply with the applicable requirements in SEC Rules 17a-3 and 17a-4, and NASD Rule 3110. Due to the complexity and varying documentation requirements of TIC exchanges, firms should examine the records they maintain and ensure that applicable record keeping requirements are satisfied.

Private Offering Exemption

Many TIC transactions are conducted without registration under the Securities Act of 1933 as private placements, most in reliance on Regulation D under that statute.¹⁴ One of the fundamental requirements of most Regulation D offerings is a prohibition on general solicitation.¹⁵ As a result of this prohibition, neither the issuer nor any person acting on its behalf may offer or sell securities based on general solicitation or general advertising, including communications published in any newspaper or similar media or any seminar or meeting whose attendees have been invited by any general solicitation or advertising.

A critical factor in determining whether a communication is appropriately limited, and thus not a “general solicitation,” is the existence of an adequate pre-existing relationship between a member and the TIC offeree. An adequate pre-existing relationship will enable the member to evaluate the potential TIC investor’s sophistication and financial circumstances.¹⁶

If a communication is made by general solicitation, then an issuer or its agents will have made a prohibited general solicitation if the communication includes an offer of the privately placed securities. If the communication references a security that is currently offered or contemplated to be offered at the time of the communication, the communication will generally be considered an offer of that security. In addition, if the person solicited via the communication is subsequently offered a security that was currently offered or contemplated to be offered at the time of the communication, the communication would generally be considered an offer of that security.

Members have requested guidance with regard to two specific methods of solicitation or advertising. In the first scenario, a registered representative who also holds a real estate license solicits potential investors by advertising a “real estate” seminar. At the seminar, investors are given a presentation on TIC exchanges and are made aware that the member offers TIC investments to its customers. Since the advertisement for the seminar would be a general solicitation, and since the references to the TIC investments currently being offered by members would be deemed an offer of those securities, the members engaged in such offerings would not be able to rely on the exemption from registration for private placements under Regulation D.¹⁷

In the second scenario, members place advertisements in newspapers and magazines that indicate that the member sells TIC interests, but the advertisements do not identify any particular TIC investment for sale by the member. Since the advertisement itself is a general solicitation, the issue for members is whether the advertisement includes an offer of securities. In general, such an advertisement would not be deemed an offer of securities if:

- ▶ the advertisement is generic;
- ▶ the advertisement is not being made in contemplation of an offering; and
- ▶ the member has procedures to ensure that an investor solicited via the advertisement will not be offered TICs that the member is currently offering or contemplating offering at the time of the initial contact.

Advertisements that do not meet each of these conditions are likely to be deemed general solicitations and inconsistent with the conditions for private placements conducted in compliance with Regulation D. Moreover, in addition to meeting these conditions, the other requirements under Regulation D also must be met, including establishing an adequate, substantive and pre-existing relationship with the investor and completing a suitability analysis prior to offering TICs to an investor.¹⁸

Endnotes

- 1 This NTM is focused on investors exchanging real estate for TIC interests. NASD is aware that some investors purchase TIC interests directly, without a corresponding exchange of real estate. Many of the concepts discussed herein are applicable to investors in TIC interests who are not exchanging real property.
- 2 See, e.g., *SEC v. Edwards*, 540 U.S. 389 (2004), 124 S. Ct. 892 (2004). See also Triple Net Leasing, LLC, SEC No-Action Letter, SEC No-Act. LEXIS 824 (Aug. 23, 2000). (The staff of the SEC's Division of Corporation Finance stated that it was unable to assure the requestor that it would not recommend enforcement action to the Commission unless the described TIC exchanges subject to a master lease agreement were registered under the Securities Act of 1933 or exempt from such registration.)
- 3 Terry Fiedler, *Buying a Little Piece of a Big Deal*, Minneapolis Star Tribune, August 16, 2004; Terry Pristin, *Money Flowing New Way to Pool Buyers*, New York Times, September 22, 2004.
- 4 The 15 factors are: Tenancy in Common Ownership; Number of Co-Owners; No Treatment of Co-Ownership as an Entity; Co-Ownership Agreement; Voting; Restrictions on Alienation; Sharing Proceeds and Liabilities upon Sale of Property; Proportionate Sharing of Profits and Losses; Proportionate Sharing of Debt; Options; No Business Activities; Management and Brokerage Agreements; Leasing Agreements; Loan Agreements; and Payments to Sponsor. Detailed information concerning these conditions is provided in Rev. Proc. 2002-22.
- 5 TIC interests in real property standing alone generally are not securities, but are a form of ownership in which each tenant (i.e., owner) holds a fractional undivided interest in real property under state real property law.
- 6 See, e.g., *SEC v. Edwards*, 540 U.S. 389 (2004); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).
- 7 Rev. Proc. 2002-22 limits the activities of TIC interest holders to those "customarily performed in connection with the maintenance and repair of rental property." Rev. Proc. 2002-22, at 18 (2002). IRB LEXIS 122 *8.
- 8 See *Stephen Thorlief Rangen*, 52 S.E.C. 1304, 1308 (1997) (finding that broker's recommendations were unsuitable where they resulted in 80 percent of the equity in customers' accounts being concentrated in one stock – "by concentrating so much of their equity in particular securities, [the broker] increased the risk of loss for these individuals beyond what is consistent with the objective of safe, non-speculative investing"). See also *Stephen Thorlief Rangen*, 53 S.E.C. 290, 292 (1997) (Order Denying Motion for Reconsideration) ("[O]ur findings of undue concentration served to support our conclusion that Rangen's recommendations were unsuitable."); *Department of Enforcement v. Daniel R. Howard*, No. C11970032, 2000 NASD Discip. LEXIS 16, at *19 (Nov. 16, 2000) (holding that the broker's recommendations "also led to an undue concentration of these speculative securities, making the recommendations particularly unsuitable"), *aff'd*, Exchange Act Rel. No. 46269, 2002 SEC LEXIS 1909 (July 26, 2002), *aff'd*, No. 02-1939, 2003 U.S. App. LEXIS 19454 (1st Cir. Sept. 19, 2003); *Dane S. Faber*, Exchange Act Rel. No. 49216, 2004 SEC LEXIS 277, at *26 (Feb. 10, 2004) ("We have repeatedly found that high concentration of investments in one or a limited number of speculative securities is not suitable for investors seeking limited risk.").
- 9 For example, members should make a reasonable investigation to ensure that any agreement associated with the TIC transaction, such as a master lease agreement with a real estate investment trust or its operating partnership, does not mandate a transaction subsequent to the acquisition of the TIC interest that would threaten the tax treatment of the acquisition under Section 1031.

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- 10 Section 15(a) of the Exchange Act excepts from registration "a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange." The intrastate exception in Section 15(a) traditionally has been narrowly and literally construed. See *Buy Blue Chip Stocks Direct*, SEC No-Action Letter, SEC No-Act. LEXIS 155 (Jan. 24, 1996); *Legacy Motors, Inc.*, SEC No-Act. LEXIS 986 (Jul. 31, 1991); *CMS Financial Group Inc.*, SEC No-Act. LEXIS 673 (Apr. 2, 1990); *Don Chamberlain*, SEC No-Act. LEXIS 3271 (Aug. 10, 1979); *National Educator's Group, Inc.*, SEC No-Act. LEXIS 2884 (Oct. 17, 1977); *American Liberty Financial Corp.*, SEC No-Act. LEXIS 2629 (Nov. 21, 1975).
- 11 See, e.g., *Dominion Resources, Inc.*, SEC No-Action Letter, 2000 SEC No-Act. LEXIS 304 (Mar. 7, 2000) (revoking prior no-action relief granted to a firm that assisted corporate and governmental issuers in structuring securities transactions and recommending broker-dealers); *John Wirthlin*, SEC No-Action Letter, 1999 SEC No-Act. LEXIS 83 (Jan. 19, 1999) (no-action relief denied to a person that would solicit investments in real estate limited partnership interests and would receive a fee if any referred investors purchased those interests); *Davenport Management, Inc.*, SEC No-Action Letter, 1993 SEC No-Act. LEXIS 624 (Apr. 13, 1993) (registration required where business broker receives transaction fees and participates in negotiations); *Woodmoor Corporation*, SEC No-Action Letter, 1972 SEC No-Act. LEXIS 1052 (Feb. 3, 1972) (real estate agent could not discuss or present any of the attributes of the security, nor provide documents connected with the investment).
- 12 A member that pays fees to an unregistered person who acts as a finder would not be deemed to violate Rule 2420 if the member obtained a no-action letter from the SEC staff indicating that the finder is not required to register as a broker-dealer.
- 13 Rule 3010(d).
- 14 17 CFR 230.501-508.
- 15 Rule 504 under Regulation D has certain exceptions from the general solicitation limitations.
- 16 *E.F. Hutton & Co. Inc.*, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2917 (Dec. 3, 1985) (In determining what constitutes general solicitation, the Division of Corporation Finance underscored the importance of substantive, pre-existing relationships with offerees prior to their being solicited); *Bateman Eichler, Hill Richards, Inc.*, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2918 (Dec. 3, 1985) (Division concurs in the view that it would not constitute a general solicitation if proposed solicitation that would be generic in nature, would not make any reference to any specific investment currently offered or contemplated to be offered at the time of the solicitation, and persons solicited are not offered any securities that were offered or contemplated for offering at the time of the solicitation); see also *H.B. Shaine & Co., Inc.*, SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2004 (May 1, 1987); *Woodtrails-Seattle, Ltd.*, SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2662 (Aug. 9, 1982).
- 17 Cf. *Aspen Grove*, SEC No-Action Letter, 1982 SEC No-Act. LEXIS 3136 (Dec. 8, 1982) (no-action relief denied where promotional brochure for limited partnership offering would be distributed at a horse auction).
- 18 See, e.g., *Bateman Eichler, Hill Richards, Inc.*, supra note 16.

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