SECURITIES ASPECTS OF REAL ESTATE SYNDICATES

Address by

Edward N. Gadsby
Chairman
Securities and Exchange Commission
Washington, D. C.

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It seems quite fitting to talk to an audience of New York lawyers about real estate for two reasons which occur to me. For one, I understand that the island of Manhattan was the scene of one of the most famous of real estate swindles with the Indians as the victims. For another reason, I understand that the present unit value of the land of which the Dutchmen skinned the red men is the highest in the world. For many years, the fee to most of this property was closely held by individuals, trustees or institutions, corporate or charitable. Until relatively recently, there were relatively few publicly held corporations whose principal business it was to own real estate. From the time when I was in Wall Street, which is not very recently however, I recall the Equitable Building Corporation, the City Investment Company, and I might think up a few more, but not very many. Even Webb & Knapp was then, as I recall it, a management company not interested primarily in owning or developing real property.

These observations are no longer completely valid. At the present time, the securities of many companies which do nothing but hold, develop or deal in real estate are listed on the various stock exchanges or are widely traded over-the-counter. There may be some special psychological gratification in being part owner of a soaring New York office building or of a nationally famous hotel. Furthermore, an investment in real estate equities appears to be attractive to certain types of persons, many of whom may not have enough capital to invest in a single building by themselves or may not care to put all their eggs in such a basket. Whatever the reason, in the last few years public offerings or participations in various real estate ventures have met with adequate response, and a new institution, the so-called real estate syndicate, has come to play a prominent role in the capital markets.

A real estate syndicate is nothing more nor less than a group of investors who join together and pool their funds to purchase a specific piece of real property. It may be a large group drawn from the general investing public or a relatively small group, all of the members of which are known to each other. The choice of form for the syndicate involves consideration of a number of factors, such as continuity of organization, transferability of the property, limitation of liability and, most important, the application of the income tax laws. It is for this last reason that promoters have usually sedulously avoided the corporate form and have most often cast the syndicate in the form of a limited partnership. Under this arrangement, the promoters occupy the role of general partners, and members of the investing public are admitted as limited partners. The actual management of the property is sometimes entrusted to a lessee or sub-lessee on a rental basis designed to produce the cash yield which is advertised to the public.

Almost any kind of property may be syndicated. The usual objects for such endeavors are apartment houses, office buildings, hotels and shopping centers. The opinion has been advanced that most of the major buildings in the nation will eventually come to be syndicate-owned. Moreover, as interest in real estate syndicates has spread, unimproved real estate has also been syndicated. A project recently coming to our attention involved desert land "improved" only by a spectacular growth of cactus. Obviously, in this case the object of investors was the realization of a capital gain through a long term increase in land values rather than an immediate return on their investment.

In any consideration of real estate syndication, it should be borne in mind that participations therein are "investment contracts" and thus are securities within the meaning of the Federal securities laws. While an offering of such participations may raise problems under others of the securities acts, particularly under the provisions of the Securities Exchange Act of 1934 relating to broker-dealers, I shall restrict myself primarily to a discussion of the Securities Act of 1933. Stated briefly and generally, this statute requires that securities offered or sold through the use of the mails or by means of interstate commerce must be registered with the Commission. Registration is accomplished by filing with the Commission a registration statement containing certain specified information and various exhibits and other documents, including a prospectus which must be furnished to each purchaser of the securities. The securities may be offered after the statement is filed but sales may not be consummated until it has become effective.

Our records show graphically the increased interest in issues of this nature. In the seven years from 1952 to and including 1958, twenty registration statements covering real estate syndicate operations were filed, aggregating $83 million. In 1959 nineteen such statements were filed, aggregating $32 million, and in 1960, to September 30, we had 22 such filings totalling $38 million. Some of you who are here today have been active in these issues and to them much of what I am saying will, no doubt, be quite old hat. Unfortunately, this familiarity apparently does not pervade the entire bar. Professor Berger of Yale did some research in the matter and pointed out in an article in the Yale Law Journal last April that the New York County Clerk's office had records of a substantial number of real estate partnerships which were not registered with us, though they obviously should have been.

The Commission has not prescribed a special form for use by real estate syndicates in registration, and Professor Berger has suggested that this omission is not only a slight to the syndicators but imposes an undue burden upon the syndicate promoters and their attorneys. The form presently used is our Form S-1 which is prescribed for most commercial and industrial offerings, and I readily admit that its various instructions may at times seem irrelevant and mysterious when the registrant is not engaged in manufacturing or selling, but proposes to own or own and manage a hotel or an office building. Nevertheless, an adaptation of Form S-1 has been developed which we believe comports with the realities of syndication, provides full disclosure to the public and offers no really serious problem to the syndicate's lawyers. This specialized format has now become familiar to everyone in the industry and its details are readily available to the uninitiated. I have no doubt that it would be possible to translate the format into a form, and we are, in fact, giving this some thought. I am personally unable to see how this would serve any very useful purpose except, perhaps, to give a measure of satisfaction to those who believe that the industry requires a formal benediction of its idiosyncrasies. We now have some 17 forms prescribed under the Securities Act of 1933, and unless some especially cogent circumstance is asserted, I would like to avoid encumbering the books with yet another series of elaborate and intricate instructions. Among other reasons which impel me to this conclusion is the fact that the syndicate agreements are tailored to fit individual situations with a noteworthy ingenuity which is difficult adequately to describe within the limits of a rigorous form. There are further complications of unknown extent relating to the real estate trusts, which I will deal with later on in this discussion.

Form S-1 involves the preparation of certain financial statements which, in a real estate syndicate deal, presents some very substantial problems. Generally speaking, these deals are on either a fee basis or a sale and leaseback basis, and our accounting requirements differ somewhat accordingly. Since the syndicates are almost invariably new organizations which are taking over properties with substantial operating histories, we require income statements of past operations, together with projections which will show how the syndicate operation will affect such earnings. You will note, however, that this does not represent a change in the dim view we notoriously take of estimates of future earnings. For instance, we do not generally permit a modification of historical results based on operating economies which the property managers expect to introduce. Nor has our position weakened with regard to the use of appraisals in balance sheets or text either, for that matter. We have found occasions where the use of figures other than cost has been justified, but they have been very rare, indeed.

The Securities Act exempts from registration certain securities and certain transactions in securities. One relevant statutory exemption encompasses transactions not involving any public offering -- the so-called private offering exemption provided by the second clause of Section 4(1) of the Act. The determination of what constitutes a public offering is a question of fact and necessitates a consideration of a multitude of circumstances. While a limitation on the number of offerees may be helpful, it will not suffice to insure that a public offering is not involved. Consideration must also be given to such factors as the size, type and manner of the offering, the character of the security concerned and especially the relationship between the offerees and the issuer. In the case of SEC v. Ralston Purina Co., the Supreme Court restricted the Section 4(1) exemption to an offering made only to those people who have ready access to the type of information which they might otherwise gather from a registration statement. It must also be remembered that the exemption does not come into existence simply because the offerees are in fact furnished adequate information about the issuer. A contrary determination would, of course, give each issuer the choice of registering or making its own voluntary disclosure free from Commission scrutiny.

Even where the offering is made to a small and knowledgeable group, the exemption will not exist if the initial purchasers have not taken the securities for investment but are operating as conduits for a distribution to the general public. Initial purchasers who thus acquire securities with a view to their resale fall into the category of statutory underwriters and any distribution by them is subject to the registration requirements. Well aware of this problem, attorneys have developed the practice of obtaining written representations that purchasers have acquired securities solely for investment and not with a view to resale. However, neither the Commission nor the courts have been impressed by the so-called investment letter, and a ritualistic recital to this effect is not conclusive nor even particularly persuasive as to the availability of the exemption. The courts and the Commission have repeatedly warned that an issuer distributes securities "at its peril." Whatever may be the excuse, an issuer will be held responsible when it sells its stock to a person who intends to and does make a public distribution thereof.

Another popular misconception is that the mere passage of time after receipt of securities establishes a presumption of investment intent. Thus, the expiration of a year after purchase has been relied upon as compelling evidence that the original investment representation has been satisfied. However, there is no statutory basis for concluding that a purchaser may shed his status as an underwriter by holding for six months, a year, or any period of time whatsoever. Of course, the length of time elapsing between acquisition and resale is one of the evidentiary facts to be considered, and the longer the period of retention the more cogent the argument that the resale is not at variance with the original commitment.

The parties also frequently point to a subsequent change of circumstance which is alleged to make a present intent to sell consistent with a prior intent to buy for investment. Whether a particular change in circumstance was not really within the contemplation of the purchaser must, of course, be determined in the light of all the available facts. Generally speaking, the Commission has tried to administer the securities laws with understanding and to keep in mind that few men receive the gift of prophecy and that an investment intent does not infer an intent to hold forever. On the other hand, it would be unrealistic for us not to recognize that a colorable change of circumstance may readily be adduced in almost every instance. Accordingly, the Commission scrutinizes the context in which securities were issued and asks for some objective evidence that they were not acquired simply as a "good deal" and as part of a portfolio of speculative securities subject to the normal vagaries thereof.

There has been some effort made to insure compliance under Section 4(1) by restricting transferability for a period of time. This really does not meet the issue. The test of the section is the intent of the purchaser who can intend to sell his participation now or at the expiration of a year from now, but in either case has taken with an intent to sell.

Another exemption often used by syndicators is the so-called intrastate exemption provided by Section 3(a)(11) of the Act. This section exempts from the registration and prospectus requirements "any security which is a part of an issue offered and sold only to persons resident within a single state or territory where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such state or territory." At the outset, you should be warned that the Commission takes the position that the exemption requires that the issuer conduct its principal business within the state of issue. It has been urged that the location of the syndicate's home office, where financial and business records are maintained, meets the "doing business" test, regardless of the location of the real estate. This is not the Commission's point of view. In the case of real estate syndicates, we believe that the principal place of business is the situs of the real property which it manages. We recently had a case where a limited partnership had been organized under New York law but had its principal asset in Arizona. It proposed to offer limited partnership interests in New York to New York residents without benefit of registration. In defense of its reliance on Section 3(a)(11), the syndicate manager pointed out that all business transactions were conducted in New York, including receipt of rental payments from the Arizona real estate, which had been leased on a long term basis. However, since the syndicate's principal asset and source of income was located outside New York, the Commission held that the 3(a)(11) exemption was not available. We took the same view in 1957 in the case of a California corporation which was to buy a hotel in Nevada, and were upheld in court.

Section 3(a)(11) requires that the entire issue be confined to a single state in which the issuer, the offerees and the purchasers are resident. Since the exemption is designed to cover only securities distributions which are essentially local in nature, the phrase "sold only to persons resident" cannot be interpreted as limited to the initial sales by the issuer if any purchasers fall into the category of statutory underwriters. It was very early held that the securities must be found only in the hands of residents who have purchased for investment and not with a view to resale to non-residents. I may say that we consider "residence" as being equivalent to "domicile," and that we do not condone sales to transients or other persons domiciled elsewhere.

Any resales to non-residents, however few, render the exemption of Section 3(a)(11) unavailable for the entire offering. The fact that representations of residence and agreements not to sell to non-residents have been carefully gathered should not be relied upon as establishing the availability of the exemption. Once more, the issuer distributes securities at his own peril, and he may well find that a devious minded purchaser has destroyed the issuer's exemption and subjected him to a heavy liability by quickly disposing of the securities to non-resident investors.

The fragility of the intra-state exemption cannot be over-emphasized. We may suppose that it was predicated on the image of a local enterprise selling to local people who, because of geographical proximity, would be in a position to understand and obtain knowledge about the business. I am not going to discuss whether or not this image is now, or ever has been entirely realistic. What is important for you to know is that the Section 3(a)(11) exemption is extremely restricted in its scope and must be handled with great care.

The limitations of the intra-state exemption are particularly important to you since the great bulk of unregistered real estate syndications have purported to rely thereon. We have reason to believe, as Professor Berger pointed out, that in some cases, at least, this reliance has been hopelessly misplaced and that the distributions have not been exempt under Section 3(a)(11). We have not to date been inclined to deploy our limited enforcement manpower against the real estate syndicates, thinking it more fruitful to center upon the boiler-rooms and other dispensers of fraudulent securities.

In this connection, it is relevant to note that most syndicates require a fairly heavy minimum participation and appeal to a fairly tax conscious, fairly high tax bracket and fairly sophisticated group. I do not mean to suggest that these people are not entitled to the protection of the securities laws, but I do suggest that they are better able to take care of themselves than is the average investor. In fact, this very ability of these purchasers to protect themselves could conceivably result in an appalling loss to an incautious promoter. I suggest, for example, that you pause and reflect upon the civil liabilities to which the syndicate managers expose themselves in dealing with substantial and sophisticated investors on the basis of anything less than a strict compliance with the securities laws and in particular a strict observance of the limitations of the intra-state exemption. Moreover, the Commission cannot be expected to continue to countenance evasions of the statute and may be expected eventually to pay a great deal more attention to the syndicate promoter who edges across the narrow margin of Section 3(a)(11).

I have assumed in this presentation that the amount involved in the syndicate operations is very substantial, as most of them are. As you know, if the matter involves less than $300,000, the exemptions authorized under Section 3(b) of the 1933 Act are available, and filings may be made under Regulation A. This technique has been employed in some cases, but I do not believe they are very common.

Under all of these exemptive provisions, serious problems arise when the transaction is being financed only in part by the syndicate operation. These integration questions take all conceivable forms, and I do not have time to do more than mention them. If they are present, they must be given very serious attention in order to make sure that they do not vitiate the protection otherwise afforded to the issuer under the law.

Finally, I think I should remind you that none of the exemptive provisions of the 1933 Act protect the issuer or the syndicate managers from the liabilities inherent in the antifraud provisions of Sections 12 and 17 of the Act. The sale by fraudulent devices, if interstate communication facilities are involved, of any security to anyone is unlawful, and subjects the seller to both civil and criminal liability.

I think that, as a final topic, I should discuss with you for a moment the real estate investment trusts which have recently been the subject of an amendment to the Internal Revenue Code. In substance, this amendment provides much the same tax treatment for qualified trusts, which are substantially limited to investments in real estate and real estate mortgages, as is provided for "regulated investment companies." Thus, such real estate investment trusts may under certain circumstances be allowed to distribute earnings to their shareholders before taxes. Since taxation as an investment company may not provide all the advantages of taxation as a partnership, the degree to which the amendment will affect the present pattern of syndication remains somewhat doubtful. Some of these tax problems were discussed in an article in the Commercial and Financial Chronicle for October 6, 1960, and I am sure that the real estate bar generally will give them close study. The only point I want to make is that the amendment does not affect the Federal securities laws. In the first place, depending upon the actual or proposed nature of its portfolio and the nature of the securities it issues, a real estate investment trust may come within the definition of an investment company as set forth in Section 3(a) of the Investment Company Act of 1940. However, an exception from the requirements of the 1940 Act is available under Section 3(c)(6) for a company whose business is primarily that of "purchasing or otherwise acquiring mortgages or other liens on and interests in real estate" so long as it is not "engaged in the business of issuing face-amount certificates of the installment type or periodic payment plan certificates."

I will admit that this provision is rather obscure upon analysis, as is true of so many provisions of the Investment Company Act. However, it is reasonably clear that the character of the trust's assets would be a crucial factor in determining the applicability of the exception. Thus, in the absence of the issue of the special types of securities referred to in the statute, the Commission would raise no question under this statute where a real estate investment trust has invested exclusively in leases or in real estate or in mortgages or liens secured by real estate. On the other hand, a trust which invests in the securities issued by another trust (as is permitted by the amendment) or in any securities of a company engaged in the real estate business or in other securities might conceivably not qualify under the exception.

Among other things, the amendment to the Internal Revenue Code requires that, in order to qualify for special tax treatment, the trust's securities must be beneficially owned by 100 or more persons. In view of this provision, it appears unlikely that the scope of the offering could be limited in such a way as to make available the so-called private offering exemption which I have previously mentioned. Whether any of the other exemptions contained in the Securities Act would be available would depend on the facts and circumstances in each case. However, it should be noted that the intra-state exemption provided by Section 3(a)(11) is not available to an investment company registered or required to be registered under the Investment Company Act, and the Commission will not be troubled in such cases by the problems presented in intra-state offerings. Where, however, the trust is designed so as not to require registration under the 1940 Act, the problem of the intra-state exemption will be the same problem which confronts the ordinary real estate syndicate.

In concluding this discussion, I might mention that we have received a number of inquiries as to the applicability of the securities laws to real estate investment trusts. I hope that these inquiries will be answered by this discussion and by a release on the subject which the Commission is issuing today, and of which I have a limited number of copies with me. However, if the advantages of this form of organization are such as to encourage its wide use, I am sure that there will be novel problems which we will be called on to answer, principally under the 1933 Act or the 1940 Act. Our staff always stands ready to consult with you on these or any other of your problems. Given the cooperation between the industry and the Commission which we have enjoyed in the past, I am sure that your difficulties will not become unduly vexatious.

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