

## Communications With the Public

### FINRA Provides Guidance on Communications With the Public Concerning Unlisted Real Estate Investment Programs

#### Executive Summary

FINRA is issuing this *Notice* to provide guidance to firms on communications with the public concerning unlisted real estate investment programs, including unlisted real estate investment trusts (REITs) and unlisted direct participation programs (DPPs) that invest in real estate.

Questions concerning this *Notice* should be directed to:

- ▶ Thomas A. Pappas, Vice President & Director, Advertising Regulation, at (240) 386-4553; or
- ▶ Amy C. Sochard, Director, Advertising Regulation, at (240) 386-4508.

#### Background and Discussion

Many firms are currently offering customers real estate investment programs in the form of either unlisted REITs or unlisted DPPs. REITs are pass-through entities that offer investors an equity interest in a pool of real estate assets, including land, buildings, shopping centers, hotels and office properties, and, in some cases, mortgages secured by real estate. As defined in FINRA Rule 2310, DPPs are investment programs that provide for flow-through tax consequences regardless of the structure of the legal entity or vehicle for distribution. DPPs include, among other investment vehicles, real estate programs that are not structured as REITs.<sup>1</sup> For purposes of this *Notice*, unlisted real estate investment programs (real estate programs) means REITs or DPPs that invest in real estate assets or mortgages and that are not listed on a national securities exchange.<sup>2</sup>

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##### Notice Type

- ▶ Consolidated Rulebook
- ▶ Guidance

##### Suggested Routing

- ▶ Advertising
- ▶ Compliance
- ▶ Legal
- ▶ Registered Representatives
- ▶ Senior Management

##### Key Topics

- ▶ Communications With the Public
- ▶ Direct Participation Programs
- ▶ Real Estate Investment Trusts

##### Referenced Rules & Notices

- ▶ FINRA Rule 2210
- ▶ FINRA Rule 2310

FINRA Rule 2210 requires that a broker-dealer's communications be fair, balanced and not misleading. Recent reviews by FINRA of communications with the public regarding real estate programs have revealed deficiencies. For example, some communications have contained inaccurate or misleading statements regarding the potential benefits of investing in real estate programs. Other communications have emphasized the distributions paid by a real estate program and failed to adequately explain that some of the distribution constitutes return of principal. In addition, some communications have not provided sufficient discussions of the risks associated with investing in the products in order to balance the presentation of benefits.

This *Notice* provides guidance to firms on communications with the public concerning real estate programs.<sup>3</sup>

### Disclosure

In describing real estate programs, firms must ensure that their communications accurately and fairly explain how the products operate. Descriptions of real estate programs in communications need to be consistent with the representations in the program's current prospectus. For example, communications that include discussion of a program's objectives that are inconsistent with the objectives included in the program's prospectus or that do not explain that there is no assurance that the objectives will be met would not meet Rule 2210's requirements.

Since an investor's participation in a real estate program is an investment in the program and not a direct investment in real estate or any other assets owned by the program, communications that imply that they are direct investments also would be inconsistent with Rule 2210's requirements. Similarly, if a real estate program has not yet qualified under the U.S. tax code as a REIT, but is being marketed as a REIT, firms should ensure that the marketing communication discloses this fact and the possibility that the real estate program may not qualify as a REIT in the future.

In applying Rule 2210's standards, FINRA requires firm communications that discuss the benefits of an investment also to include a discussion of its risks.<sup>4</sup> Accordingly, firm communications concerning real estate programs must balance any presentation of the potential benefits of such investments with disclosure concerning potential risks. This balance will be achieved if risk disclosure is presented in a clear and prominent manner, commensurate with the discussion of benefits, and is not relegated to a footnote.<sup>5</sup> Providing risk disclosure in a separate document, such as the prospectus, does not substitute for the required disclosure, even if a communication is accompanied or preceded by a prospectus.

### Distribution Rates

Firm communications concerning real estate programs often include distribution rates. Some real estate programs fund a portion of their distributions through return of principal or loan proceeds. For example, a portion of a newer program's distributions might include a return of principal until its real estate assets are generating significant cash flows from operations.

Rule 2210(d)(1)(B) prohibits firm communications from making any false, exaggerated, unwarranted, promissory or misleading claim. Accordingly, the rule prohibits firms from misrepresenting the amount or composition of a real estate program's distributions. Nor may firms state or imply that a distribution rate is a "yield" or "current yield" or that investment in the program is comparable to a fixed income investment such as a bond or note.

Presentations of distribution rates will be deemed to comply with Rule 2210's requirements that communications be fair and balanced, provided that the presentations clearly and prominently disclose:

- ▶ that distribution payments are not guaranteed and may be modified at the program's discretion;
- ▶ if the distribution rate consists of return of principal (including offering proceeds) or borrowings, a breakdown of the components of the distribution rate showing what portion of the quoted percentage represents cash flows from the program's investments or operations, what portion represents return of principal and what portion represents borrowings;
- ▶ the time period during which the distributions have been funded from return of principal (including offering proceeds), borrowings or any sources other than cash flows from investment or operations;
- ▶ if the distributions include a return of principal, that by returning principal to investors, the program will have less money to invest, which may lower its overall return; and
- ▶ if the distributions include borrowed funds, that because borrowed funds were used to pay distributions, the distribution rate may not be sustainable.

In order to be fair and balanced, firm communications concerning a real estate program may not include an annualized distribution rate until the program has paid distributions that are, on an annualized basis, at a minimum equal to that rate for at least two consecutive full quarterly periods.

### Stability/Volatility Claims

Rule 2210(d)(1)(A) requires firm communications to provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry or service. In addition, Rule 2210(d)(1)(D) requires communications to be consistent with the risks of fluctuating prices and the uncertainty of dividends, rates of return and yield inherent to investments.

Accordingly, a firm may not assert or imply in communications that the value of a real estate program is stable or that its volatility is limited without providing a sound basis to evaluate this claim. The fact that a program offers its securities at par value, or at another relatively stable price, does not evidence stability in the value of the underlying assets. A communication also may not state that the price at which the program is offered is stable or that its volatility is limited without disclosing that price stability does not indicate stability in the value of the underlying assets, which will fluctuate and may be worth less than the real estate program initially paid, and that the investor may not be able to sell the investment.

### Redemption Features and Liquidity Events

Rule 2210(d)(1)(A) prohibits firms from omitting any material fact or qualification if the omission, in light of the context of the material presented, would cause the communications to be misleading. A communication could be misleading under this provision if it discusses a redemption feature without clearly and prominently explaining the restrictions and limitations of this feature, such as the fact that the real estate program's management may terminate or modify the ability to redeem. The fact that the real estate program has not satisfied all investor redemption requests in the past could be considered a fact that should be disclosed under this provision.

Any discussion about potential liquidity events or the timing of such events must be factual and balanced. A communication may not be balanced if it fails to disclose that the date of any liquidity event is not guaranteed or, if applicable, that it may be changed at the program management's discretion.<sup>6</sup>

### Performance of Prior Related Real Estate Programs

If a communication includes prior performance or other historical information about related or affiliated entities, this information may not be "cherry-picked" from other programs; information about all related or affiliated programs should be included with equal prominence. Moreover, firms should ensure that this information is presented to easily differentiate it from information about the current program. Of course, the information must be consistent with information in the program's prospectus.

### **Use of Indices and Comparisons**

Communications concerning real estate programs often use a real estate index's performance to demonstrate the sector's risk or return characteristics. As discussed above, Rule 2210(d)(1)(B) prohibits firms from making false or misleading statements or claims. In addition, Rule 2210(d)(2) requires that any comparison in retail communications between investments or services disclose all material differences between them, including (as applicable), investment objectives, costs and expenses, liquidity, safety, guarantees or insurance, fluctuation of principal or return, and tax features.

The use of any given index performance may be misleading if its underlying components do not correspond with those of the program's portfolio. For example, it would be misleading to cite the performance of an index of traded REITs to indicate how an unlisted REIT may perform.

In order to make a fair comparison if a communication includes an appropriate index, the communication must indicate the performance is not that of a particular real estate program, and describe the index's components and any relevant differences with the program's portfolio investments.

### **Pictures of Specific Properties**

Communications for a new program often include photographs or other images of properties owned by investments managed by the program's sponsor that are similar to properties the program expects to purchase. In order to be clear that investors will not acquire an interest in the pictured property, prominent text must accompany each depiction explaining that the property is owned by an investment managed by the sponsor and not the program. Once the real estate program has acquired a portfolio, the communication may include depictions of properties that are limited to investments owned by the program.

A communication concerning a real estate program that holds real estate mortgages may include photographs or other images of properties in which the program has a security interest as long as the communication discloses that the program does not own the property and that the property is collateral for a loan owned by the program.

## Capitalization Rates

A communication may include a capitalization rate for an individual property within a real estate program if the rate is based on current information contained in the prospectus, and the communication explains how the rate was calculated, that the rate applies to the individual property, and that it does not reflect a return or distribution from the REIT or DPP itself. As a general matter, however, it is misleading for a communication to include a rate that reflects a blending of multiple individual properties' capitalization rates. Individual properties within a program's portfolio typically will have different acquisition dates and their respective capitalization rates, which are generally based on the acquisition price of the property, may not reflect their current values. In addition, the individual properties' capitalization rates may reflect different calculation methodologies.

## Endnotes

1. See FINRA Rule 2310(a)(4) for a complete definition of "direct participation program."
2. Real estate programs may be registered under the Securities Act of 1933 or may be offered pursuant to an exemption from such registration. The guidance in this *Notice* applies to communications regarding registered and non-registered real estate programs.
3. On December 19, 2011, the SEC's Division of Corporation Finance issued *CF Disclosure Guidance: Topic No. 3*, which discusses the SEC staff's views on a number of issues regarding materials submitted to the SEC staff pursuant to *Securities Act Industry Guide 5* (SEC Guidance). Guide 5 applies to real estate limited partnerships and unlisted REITs. The guidance in this *Notice* is intended to be consistent with the SEC Guidance.
4. See FINRA Rule 2210(d)(1)(D).
5. Information may be placed in a legend or footnote only in the event that such placement would not inhibit an investor's understanding of the communication. FINRA Rule 2210(d)(1)(C).
6. Under FINRA Rule 2310(b)(3)(D), before executing a purchase transaction in a public offering of DPP or unlisted REIT securities, a firm or associated person must inform the prospective participant of all pertinent facts relating to the liquidity and marketability of the DPP or REIT securities during the term of the investment. Included in the pertinent facts must be information regarding whether the sponsor has offered prior DPPs or unlisted REITs for which offering materials disclosed a date or time period at which the DPP or REIT might be liquidated, and whether liquidation occurred around that date or during the time period. This requirement does not apply to securities offerings of certain DPPs that are either listed or reasonably expected to be listed on a national securities exchange.

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