

## **NIN96/36 REAL ESTATE SECURITIES [NIN - RESCINDED]**

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#### Introduction

The Commission is issuing this Notice to provide guidance on when sales of interests in real estate constitute investment contracts and, consequently, securities as defined in section 1(1) of the Securities Act, S.B.C. 1985, c. 83. Generally, real estate properties will be considered to be securities where they are comprised of a direct interest in real estate, typically a strata lot, together with an ancillary agreement, usually with the promoter, developer or manager, for (i) project management combined with rental or cash flow guarantees or other financial commitments and/or (ii) revenue and/or expense pooling, whereby, in either case, the purchaser places significant reliance on the skill or expertise of another person to realize an economic return from the investment. Any offering of real estate securities must be in compliance with the registration and prospectus requirements of the Act, or in accordance with a statutory or discretionary exemption.

Over the past several months, staff of the Commission has been working with the Superintendent of Real Estate and a focus group comprised of real estate and securities lawyers to attempt to resolve the overlap between the regulation of securities and real estate transactions. The Commission had been considering granting fairly broad relief from the registration and prospectus requirements for rental pool securities. The Commission issued ad hoc relief for one project on the basis of that approach.

The offering where ad hoc relief was provided demonstrated to staff that certain real estate offerings represent classic investment contracts that should be regulated under the Act. The offering in question involved the sale of strata lots in a hotel that were subject to a mandatory rental pool agreement and included a guaranteed gross return provided by the developer for a period of five years. Purchasers were not entitled to occupy the strata lot and effectively had no control over the management or operation of the hotel business. The structure and marketing of the offering focused on the return expected to be derived from participation in the hotel business, and not the real estate aspects of the offering.

Notwithstanding the ad hoc relief provided, the Commission has concluded that offerings of real estate securities such as those referred to above should be regulated as distributions of securities. The offerings may also be subject to regulation under the Real Estate Act, R.S.B.C. 1979, c.356.

There are other types of real estate securities offerings where the economic value of the investment is primarily related to the interest in real estate. The Commission considers that, under appropriate conditions, these offerings can be adequately regulated by the Real Estate Act. At this time, the Commission is prepared to provide interim blanket relief from the requirements of the Securities Act to register and to file a prospectus for a trade in an "Optional Rental Pool Security" (see discussion under "Exemptive Relief for Optional Rental Pool Securities"). Relief for other types of real estate securities offerings will be considered case by case on application (see discussion under "Other Exemptive Relief").

#### Real Estate Investments as Securities

Courts and regulators in both Canada and the United States have examined a variety of business arrangements to determine whether they constitute investment contracts. Two basic tests have been developed for determining the existence of an investment contract. Under the "Howey" or "common enterprise" test, an investment contract is found to exist where a person is invited to make an investment in a common enterprise with an

expectation of profit produced primarily through the efforts of others. Under the "Hawaii" or "risk capital" test, an investment contract is found to exist where a purchaser furnishes to a seller initial value, a proportion of which is subjected to the risks of the enterprise, with an understanding that a valuable benefit will accrue to the purchaser as a result of the operation of the enterprise, and the purchaser does not obtain the right to practical and actual control over the managerial operation of the enterprise.

Although any particular arrangement must be examined on its own merits, an offering of real estate together with (i) an agreement for project management combined with rental or cash flow guarantees, or other financial commitments, and/or (ii) revenue and/or expense pooling, would generally have characteristics that bring it within the concept of an investment contract and therefore make it subject to regulation under the Act.

A rental pool agreement is entered into between an owner of a property and a rental manager. Under the agreement, the manager is authorized by the owner to rent property, and revenues derived from the rental of the property and other properties are to be pooled and the profits from the pool are to be shared among the owners of the properties in accordance with their proportionate interests in the pool. The manager's expenses to market, rent and maintain the properties in the pool are either paid by the manager or paid by the owners of the properties from the rental revenues that the manager collects. In consideration for marketing, renting and managing the properties in the pool, the manager is usually entitled to a management fee.

Other types of real estate investments may also be securities. Anyone conducting an offering of these investment instruments must comply with the Act and should seek legal advice if necessary.

The Commission views various types of real estate securities as falling in a continuum. At one end of the continuum are classic investment contracts that should be subject to the general regulatory requirements of the Act. At the other end of the continuum are those for which the investment contract is a minor or incidental aspect of the investment. Other types of investments may fall along the continuum between these extremes.

#### Regulation of Real Estate Securities

A person that trades a real estate security must be registered under section 20(1)(a) of the Act, rely on a statutory exemption from the registration requirements, or obtain a discretionary exemption order from the Commission. For example, real estate securities can be traded under section 31(1)(5) of the Act or section 89(b) of the Securities Rules, B.C. Reg. 479/95, which exempt from the registration requirement in section 20(1)(a) of the Act a trade of a security that has an aggregate acquisition cost of not less than \$97,000 or \$25,000 respectively, on compliance with additional requirements set out in those sections. Note that these exemptions from registration are only with respect to trading, and not for advising about, a security. Section 20(1)(c) of the Act requires a person who acts as an adviser to be registered as an adviser or as an advising employee, partner, director or officer of a registered adviser, subject to certain limited exemptions set out in section 30 of the Act.

An issuer that distributes a security must file a prospectus under section 42 of the Act, rely on a statutory exemption from the requirement to file a prospectus, or obtain a discretionary exemption order from the Commission. Real estate securities have generally been distributed under two prospectus exemptions, section 55(2)(4) of the Act where the aggregate acquisition cost is not less than \$97,000 and section 128(b) of the Rules where the aggregate acquisition cost is not less than \$25,000. Section 134(2) of the Rules requires that, where a person advertises in connection with a distribution of a security under section 55(2)(4) of the Act, the person must deliver an offering memorandum in compliance with section 133 of the Rules. Section 128(b) of the Rules also requires that an offering memorandum be delivered and that the purchaser be a "sophisticated purchaser" as defined in the Rules.

## Form of Offering Memorandum and Prospectus Specific to Real Estate Securities

Except where a prospectus has been filed under the Securities Act, sections 50 and 50.1 of the Real Estate Act require that a developer also file with the Superintendent of Real Estate a disclosure statement or prospectus, as appropriate, in the form required by that Act, and distribute the document to potential purchasers prior to the sale of subdivided land. The Commission and the Superintendent of Real Estate recognize that this duplicative disclosure necessitates additional time and expense for developers and may confuse purchasers of real estate securities. To avoid this duplicative disclosure and simplify compliance with both the Real Estate Act and the Securities Act, the Executive Director of the Securities Commission has specified a new form of offering memorandum that includes the required real estate disclosure form together with certain additional disclosure in a single, integrated disclosure document.

Under NIN#96/37, the Executive Director has specified Interim Form 43B as the required form of offering memorandum under section 133(1)(c) of the Rules for a distribution of real estate securities. Interim Form 43B includes the disclosure required under the Real Estate Act and additional disclosure intended to ensure that investors in real estate securities receive sufficient disclosure to make an informed investment decision, and sufficient notice of their rights and protections under both the Real Estate Act and the Securities Act.

Staff of the Commission is also in the process of preparing a form of prospectus for real estate securities, based largely on Interim Form 43B.

### Exemptive Relief for Optional Rental Pool Securities

The Commission has determined that Optional Rental Pool Securities should be exempted, on an interim basis, from the registration and prospectus requirements of the Act. An Optional Rental Pool Security is a real estate security

- (a) comprised of a direct interest in a residential property and the option of entering into a rental pool agreement for that property,
- (b) without any ancillary rental or cash flow guarantee, or other financial commitment on the part of any person connected with the offering,
- (c) where the rental pool is entered into at the sole discretion of the owner and is terminable by the owner at any time at the owner's sole discretion, with reasonable notice or on other reasonable conditions, and
- (d) where the owner has the right to occupy the property at any time, with reasonable notice.

Under BOR#96/19, the Commission has exempted, on an interim basis, the following:

(a) an intended trade of an Optional Rental Pool Security by a developer, or a real estate agent acting on its behalf, from the requirement to file a prospectus under section 42 of the Act, provided that:

- (i) the developer has filed with the Superintendent of Real Estate, under Part 2 of the Real Estate Act, and delivered to the purchaser, a disclosure statement or prospectus in the form required by Interim Form 43B, excluding Items 4 (2), (3), (4), 6, 8, 14, 18 and 19;
- (ii) the rental pool agreement requires the manager of the rental pool to provide a purchaser with access to reasonably detailed

information as to revenues and expenses for the rental pool for the two year period before the date of the initial trade or any subsequent trades, as the case may be, to the extent that the rental pool has been operating during that two year period;

(iii) there is no marketing or promotion of the expected economic benefits of the rental pool; and

(iv) the developer and any real estate agent acting on its behalf complies with all applicable provisions of the Real Estate Act;

(b) developers, and real estate agents acting on their behalf, from the requirement in section 20(1)(a) of the Act to register to trade an Optional Rental Pool Security provided the conditions stated in (a) above are met; and

(c) a subsequent trade by a holder of an Optional Rental Pool Security from the requirement in section 20(1)(a) of the Act to register to trade and the requirement in section 42 of the Act to file a prospectus, provided that, in either case, the holder complies with all applicable provisions of the Real Estate Act, and there is no marketing or promotion of the expected economic benefits of the rental pool.

No filings with the Securities Commission are required for trades done in compliance with BOR#96/19.

BOR#96/19 does not provide an exemption from the requirement to be registered to act as an adviser. For example, persons who are licensed under the Real Estate Act and persons who are exempt from the licensing requirements of that Act, such as a full time salaried employee of a principal to a real estate transaction where the employee is acting for or on behalf of his employer, may sell an Optional Rental Pool Security under the trading exemption. They are not exempted from the registration requirement for advisers in section 20(1)(c) of the Securities Act. These persons are permitted to give factual information about the Optional Rental Pool Security to prospective purchasers, but they are not permitted to give opinions on the investment merits of the Optional Rental Pool Security or indicate that the investment would be suitable for any particular investor.

#### Other Exemptive Relief

On application, the Commission or the Executive Director will consider whether an exemption order should be issued for offerings of real estate securities, other than Optional Rental Pool Securities, that fall at the real estate end of the continuum of real estate securities. In specific cases where it can be demonstrated, by reference both to the structure of the transaction and to the proposed marketing methods and materials, that the purchaser will not place significant reliance on the skill or expertise of another person to realize an economic return from the investment, staff of the Commission will generally be prepared to recommend that the Commission or the Executive Director, as the case may be, grant an exemption from the prospectus and/or registration requirements of the Act, subject to appropriate conditions. For those offerings in the middle of the continuum, staff may recommend exemptions, which may be subject to additional restrictions on eligible purchasers and resales. It is unlikely that staff of the Commission will recommend exemptive relief for projects at the securities end of the continuum.

#### Marketing of Real Estate Securities

The Commission is concerned about the methods and materials used in the marketing and

promotion of real estate securities. In addition to any requirements under the real estate regulatory regime that apply to the advertising of real estate securities, the Commission has a number of requirements that apply to the marketing and promotion of securities generally. Rather than referring developers and their professional advisers to those requirements, the Commission is issuing guidelines, set out in this Notice, specific to the marketing and promotion of real estate securities.

These guidelines, and the general prohibitions in the Act against fraud and misrepresentation, apply to any offering of real estate securities, whether done under a prospectus or an exemption, including BOR#96/19.

The Commission is aware that full disclosure can seldom be encompassed in an advertisement and, as a result, expects advertisements and other promotional materials to be worded so as to encourage the recipient to consult the relevant disclosure statement, offering memorandum or prospectus. Advertisements, sales literature, other promotional materials and oral representations must be free of quotations, opinions, data and other information that may lead the recipient to make incorrect inferences. Above all, partial disclosure of a series of facts and figures must be avoided when full disclosure of such facts and figures is required for a proper comprehension of the offering. Promotional assertions must be substantiated by reference to disclosure of facts in the related disclosure statement, offering memorandum or prospectus.

Due to the frequent misinterpretation by investors of words such as "guaranteed", "preferred", "liquid" and "indemnity", these words must not be used in any marketing or promotional materials or representations for real estate securities. When other modifiers are used, their context must be made perfectly clear. The onus is on the developer or promoter to avoid using equivocal words and phrases and to ensure that all marketing and promotional materials are worded so that a recipient cannot reasonably be misled.

A reference to a benefit, or a comparison of outlay and benefits or returns from outlay, must be free of equivocation. For example, if a reference is made to a benefit that has specific conditions or contingencies riding on it, a reference must also be made to such conditional aspects. If matched columns of figures representing outlay and recovery, or outlay and tax benefits resulting from such outlay, are disclosed, the recipient is entitled to infer that no conditions attach to such figures unless such conditions are clearly disclosed. Where full disclosure on such points cannot be achieved in the materials and representations, partial disclosure must be avoided.

Reference to historical financial data must be based on the results for at least three consecutive years. When there has been less than three years' history, any disclosure of financial data must be accompanied by a caveat to this effect.

Any financial forecasts or projections must be prepared in accordance with section 4250 of the CICA Handbook and must be audited in accordance with the Auditing and Related Services Guideline of the CICA Handbook entitled "Examination of a financial forecast or projection included in a prospectus or other offering document".

All advertisements and other marketing and promotional materials must contain a disclaimer stating that it must not be construed as an offering and that the offering is made only by disclosure statement, offering memorandum or prospectus. In addition, these materials should disclose the name and address of at least one person from whom more information and a copy of the relevant disclosure statement, offering memorandum or prospectus may be obtained.

#### Comments

The Commission is in the process of developing a long-term policy with respect to all real estate securities. Accordingly, the Commission is interested in receiving comments on the Notice, the Interim Blanket Order, and on matters the Commission should consider in developing its long-term policy. Interested persons are encouraged to direct written

comments by December 15, 1996 to:

Brenda J. Benham  
Director  
Policy and Legislation  
British Columbia Securities Commission  
1100 - 865 Hornby Street  
Vancouver, BC V6Z 2H4

Comment letters submitted in response to Requests for Comment are placed in the public file and form part of the public record, unless confidentiality is requested. Although comment letters requesting confidentiality will not be placed in the public file, freedom of information legislation may require the Commission to make comment letters available. Persons submitting comment letters should therefore be aware that the press and members of the public may be able to obtain access to any comment letter.

DATED at Vancouver, British Columbia, on October 10, 1996

Douglas M. Hyndman  
Chair

References: Interim Form 43B  
NIN#96/37  
BOR#96/19

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