

Client Alert

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FINRA Identifies Concerns with Marketing of Real Estate Investment Products

By Kelley A. Howes and Jay G. Baris

FINRA recently signaled a continuing focus on the marketing of real estate-related products by issuing a Regulatory Notice expressing concerns about communications involving unlisted, or non-traded, real estate investment trusts (REITs) and real estate direct participation programs (DPPs).

While the Notice does not break new ground, FINRA explained that its recent reviews of communications have revealed compliance deficiencies in this area. In addition, some of the themes emphasized in the Notice reflect concerns expressed in recent FINRA disciplinary actions, as well as in FINRA's 2013 Regulatory and Examination Priorities Letter. Private real estate funds that engage FINRA-registered placement agents should carefully consider these issues.

Communications with the public. FINRA Rule 2210 generally requires that members' communications with the public be fair, balanced and not misleading. In its Notice, FINRA identified several areas where members' communications may not be consistent with that standard.

Disclosure. Members must ensure that communications with the public balance the discussion of the potential benefits of investing in REITs or DPPs with the risks of such investments. Moreover, marketing communications must be consistent with the disclosure in a program's current prospectus.

- Discussions of investment objectives must be consistent with the disclosure in the prospectus and should state that there is no assurance that investment objectives will be met.
- Communications that imply that an investment in a REIT or DPP is a direct investment in real estate are inconsistent with Rule 2210.
- If a REIT is not yet qualified under the tax code, marketing communications should clearly disclose that fact and the possibility that the program may not qualify as a REIT in the future.
- In general, risk disclosure should not be relegated to a footnote or provided in a separate document, but should be presented in a "clear and prominent manner."

Distribution Rates. Marketing communications that include distribution rates must include the following disclosure:

- Distribution rates are not guaranteed and may be modified;
- If the distribution rate consists of return of principal or borrowings, a breakdown of the portions of the distribution rate that result from cash flow from operations, return of principal and borrowings;
- The time period during which distributions have been funded by sources other than cash flow from operations;

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- If the distribution rates include return of principal, a disclosure that this use of principal decreases the program's investable assets which could result in lower overall returns; and
- If the distributions include borrowings, a disclosure that the distribution rate may not be sustainable.

FINRA also stated that REIT and DPP communications 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.

Balancing Risks and Benefits. FINRA identified several specific areas where members should ensure that they are providing investors with enough information to evaluate the investment or adequately balancing the discussion of the potential benefits of investing in a REIT or DPP with the risks of those investments.

- A firm may not assert or imply that the value of a real estate investment program is stable or that its volatility is limited without providing a sound basis to evaluate this claim. Even if a REIT or DPP offers its securities at a stable price, members must disclose that such stability does not reflect stability in the value of the underlying assets, which will fluctuate, and that an investor may not be able to sell its investment.
- Marketing communications could be deemed to be misleading in violation of Rule 2210 if they do not clearly and prominently explain the restrictions and limitations of any redemption features or liquidity features of a REIT or DPP. In particular, the fact that a program has not previously satisfied investor redemption requests should be disclosed.
- If communications include information about prior performance of related or affiliated entities, members must include information about all related or affiliated programs with equal prominence. That is, members cannot "cherry-pick" prior performance information.
- Communications that use a real estate index's performance to demonstrate the sector's risk or return characteristics may be misleading if underlying components of the index do not correspond to those in the program's portfolio. Even if the use of a particular index is appropriate, members should clarify that index performance is not that of a particular real estate program, describe the components of the index and identify any relevant differences between the index components and the REIT or DPP portfolio investments.
- If communications include pictures of properties owned by other investments managed by a program's sponsor, they must include prominent text explaining that the property is owned by a different investment managed by the sponsor and not the current program.
- Although communications may include a capitalization rate for an individual property within a REIT or DPP, as a general matter it is misleading to include a rate that reflects a blending of multiple individual properties' capitalization rates.

FINRA's guidance applies equally to communications regarding registered and non-registered real estate investment programs. FINRA also specifically stated that its guidance is intended to be consistent with guidance issued by the Securities and Exchange Commission in [*CF Disclosure Guidance: Topic No. 3*](#).

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