Client Alert

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Broker-Dealer Registration Issues Associated with Development Projects under the EB-5 Program

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The EB-5 Immigrant Investor Program (the "EB-5 Program") administered by the U.S. Citizenship and Immigration Service (USCIS) has been a significant source of capital for various real estate and other development projects throughout the United States. Because capital contributed by foreign nationals under the EB-5 Program typically takes the form of an investment in a limited partnership, the sale of these interests can have securities law implications. Not surprisingly, the SEC has begun to look at some of these issues. This Alert will discuss the broker-dealer registration issues presented by projects that use the EB-5 Program.

The EB-5 Program offers visas allowing residence in the United States to qualified immigrants who make an investment of at least $1,000,000 (or at least $500,000 for investments made in a "Targeted Employment Area") in a new commercial enterprise that will create full-time jobs for at least ten qualified individuals, or maintain that number of existing employees in a "troubled business." Investments in EB-5 projects most often are made through "regional centers," which are economic entities approved by the USCIS to oversee raising funds from foreign investors and creating jobs through the U.S. development project.

Typically, to take advantage of these potential investment dollars, a regional center forms a special purpose vehicle that raises funds through the EB-5 Program, and provides these funds to the developer as part of the financing for the development project. An EB-5 project developer through the regional center typically raises funds from would-be immigrants through overseas "finders." Those foreign investors typically become limited partners in a limited partnership or limited liability company formed by the regional center to provide financing for the development project.

In a conference call held on April 3, 2013, among the SEC staff and various stakeholders of the EB-5 Program, the SEC discussed the circumstances under which regional centers or finders raising funds under the EB-5 Program are required to register as broker-dealers or associated persons under the federal securities laws. According to the SEC staff, whether registration is required depends principally on whether potential investors are solicited, how the sellers of investment interests are compensated, and the nature of the activities undertaken by an issuer and its "associated persons" in connection with the offer and sale of an investment under the EB-5 Program, including whether such activities comply with the safe harbor for "associated persons" under federal securities laws.

The consequences of the failure to comply with broker-dealer registration requirements are potentially severe; using unregistered broker-dealers in connection with the offer and sale of EB-5 investments could trigger enforcement investigations or actions involving the issuer, the regional center and other associated persons. Government scrutiny could jeopardize the success of the project and raise reputational issues for any developer, financial institution or other lender associated with the project. A failure to satisfy broker-dealer registration requirements also might give rise to a right of rescission for investors who seek to terminate their investments.

BROKER-DEALER REGISTRATION UNDER THE EXCHANGE ACT

Under the federal securities laws, any person or entity that makes use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security must be registered as or be associated with a broker-dealer. As a general matter, an entity needs to register as a broker-dealer if it is engages in the business of securities transactions. According to the securities laws and related SEC guidance, among the factors to look at in making that determination include whether the entity:

- is in the business of transacting securities on a regular basis;
- receives transaction-based compensation;
- advertises or holds itself out as a broker;
- takes custody of client's funds;
- negotiates or otherwise actively participates in the sales process; and
- actively solicits investors.

In addition to complying with the federal securities laws, EB-5 financings must be structured in a manner that complies with broker-dealer regulations under applicable state law.

THE USE OF FINDERS

In a typical deal that uses EB-5 funds, foreign finders are retained by a regional center – either directly or through a foreign entity – to raise funds from foreign investors. Regional center employees might assist in the fund-raising, perhaps by attending presentations to foreign investors. The foreign finders who locate potential investors for EB-5 projects typically are paid a fee based on the amount of investment they bring; in other words, their compensation is typically transaction-based. During the April 3 conference call, the SEC staff stated that the receipt of transaction-based compensation almost invariably would require broker-dealer registration if such selling activities fall within the territorial reach of the SEC.

As a general matter, the SEC does not have jurisdiction over securities sales activities that occur exclusively overseas; that is, if a finder's selling activities are conducted solely overseas, the finder is not a U.S. person, and the finder otherwise has no jurisdictional nexus with the United States. It is therefore important to limit the foreign finder's contacts with the U.S. According to the staff, the SEC's territorial reach could encompass, for example, a finder that has an office located in the United States. Thus, an ideal structure would involve foreign finders who are engaged by a foreign entity whose only contacts with the United States are the transmission of investors' funds to the special purpose entity formed by the regional center to provide financing for the project, and the receipt of funds of compensation from the regional center. If the finder has more significant contacts with the U.S., it could attempt to limit its activities so that it does not come within the definition of acting as a broker-dealer. It could do so by avoiding the "badges" of broker-dealer activities, which include active solicitation of investors, receipt of transaction-based compensation or repeated involvement in the sales of investments.

THE ISSUER EXEMPTION AND SAFE HARBOR FOR ASSOCIATED PERSONS

Under the federal securities laws, the special purpose vehicle that originates the EB-5 investments does not have to register as a broker-dealer because it is not a "broker" – it sells securities for its own account and not for the accounts of others – and is not a "dealer" – it does not buy and sell its securities for its own account as part of a regular business. However, a regional center, and employees and other natural persons acting on behalf of the special purpose vehicle or regional center in connection with the sale of EB-5 investments, might be required to register as a broker-dealer or associated person if they engage in broker-dealer activities.

Natural persons acting on behalf of the special purpose vehicle or regional center may be able to take advantage of the securities laws' safe harbor exemption from registration for a partner, officer, director or employee of the issuer and other "associated persons of an issuer." The safe harbor applies to individuals who, among other things, are not subject to a statutory disqualification and do not receive any transaction-based compensation. In addition, the safe harbor requires either (1) that the person's activities be limited to passive selling efforts that involve no solicitation of potential investors, communications that generally are limited to delivering approved written communications, and performing ministerial and clerical work in effecting sales, or (2) if such person's activities go beyond such passive selling efforts, then such person must primarily perform substantial duties for the issuer other than selling the issuer's securities, and must not have participated in an offering of securities more than once in each 12-month period.

Thus, for example, a meeting in China in which a regional center employee discusses the investment with a potential investor might exceed the permissible scope of activities permitted under the exception for "passive" selling efforts because the meeting could be deemed to be a form of solicitation to induce the potential purchaser to purchase securities. To qualify for the safe harbor, such associated person engaged in a solicitation must not have participated in an offering of securities within the last 12 months prior to the meeting in China and his roles, duties and compensation must meet the safe harbor's other limitations and requirements. However, note that the safe harbor does not prevent a representative of the regional center from engaging in passive selling efforts by attending a meeting in China and doing no more than delivering written communications from the issuer and answering questions with information that is drawn straight from the offering documents.

SUITABILITY CONSIDERATIONS

On occasion, member broker-dealers participate in EB-5 financings. FINRA recently made clear in an Interpretive Letter that when the entity that offers or sells the securities in connection with an EB-5 project is a member broker-dealer, the broker-dealer is subject to FINRA's suitability rule. The fact that the customers are foreign nationals makes the safeguards provided by the suitability rule no less important. Indeed, the fact that the investment is being made pursuant to EB-5 adds additional considerations to the firm's suitability analysis. In determining the "reasonable basis" suitability of the investment, that is, whether the investment is suitable for at least some investors, the broker-dealer needs to consider the legitimacy and viability of the enterprise, and whether the private placement will satisfy the requirements of the EB-5 program. In addition, in considering the suitability of the investment for specific customers, the broker-dealer may take into consideration the fact that at least part of the customer's motivation for making the investment is to seek U.S. residency.

CONSEQUENCES OF USING UNREGISTERED BROKER-DEALERS TO SELL EB-5 INTERESTS

Developers or other job creators who take advantage of the EB-5 Program should be aware of the broker-dealer registration issues associated with the sales of investments, lest these collateral issues threaten the success of the project. An entity or its employees that solicit or sell investments in an EB-5 project must register as a broker-dealer or satisfy the terms of an exemption or safe harbor from registration, and the failure to register or satisfy those conditions could trigger a host of adverse consequences. A regional center that engages an unregistered broker-dealer could find itself subject to an SEC investigation or enforcement action for aiding and abetting an Exchange Act violation. Investors who acquired EB-5 investments from an unregistered broker-dealer could have a right of rescission and might seek damages under federal and state securities laws. The project developer and all other participants in the project could find the project delayed or complicated by government action or private rights of action based on the registration oversights, and could suffer reputational harm. The Regional Center or any other entity involved in the project also runs the risk of losing potential exemptions from broker-dealer or securities registration requirements under the "bad actor" provisions of the federal and state securities laws.

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