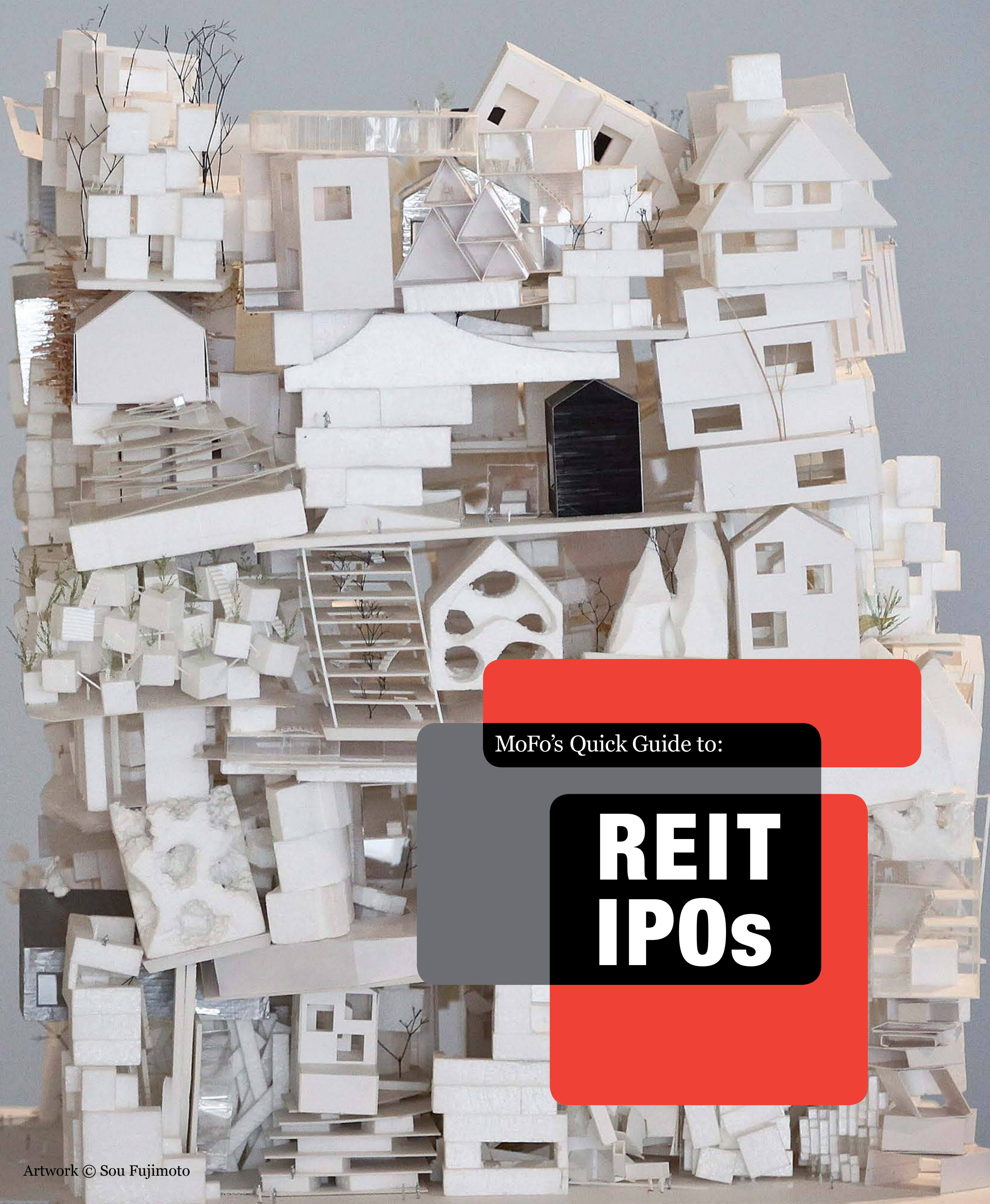
2018 Morrison & Foerster

MoFo's Quick Guide to:

REIT IPOs



Artwork © Sou Fujimoto

> *"Why, land is the only thing in the world worth workin' for, worth fightin' for, worth dyin' for, because it's the only thing that lasts."*
>
> Gone with the Wind (1939)

Real estate investment trusts ("REITs") are endlessly inventive. They were first developed in the 1960s as a means for ordinary retail investors to hold interests in real estate. The REIT market has waxed and waned over the years. During the early years of the Great Recession, 2008-2009, REITs surged in popularity due to their dividend yields, among other things, then they slowed down. However, the past few years have been excellent years for REITs.

REIT market participants have started *de novo* REITs, including equity REITs and mortgage REITs, or have converted existing organizations into REITs. Both new REITs and private REITs have filed registration statements with the Securities and Exchange Commission ("SEC") for proposed initial public offerings ("IPOs").

A REIT is an investment vehicle designed to allow investors to pool capital to invest in real estate assets. It has certain advantages over other investment vehicles; in particular, a REIT is not subject to U.S. federal income tax on the taxable income that it distributes to shareholders even if its equity is publicly traded. Investors seeking current distributions choose to invest in REITs because REITs must distribute 90% of their taxable income in order to maintain REIT status. REITs generally finance their activities through equity and debt offerings. Although there is an active private market for REIT securities, REIT sponsors often have chosen to pursue IPOs.

There are now many different flavors of REITs. Most broadly, there are equity REITs that own primarily interests in real property and mortgage REITs that own primarily loans secured by interests in real property. Equity REITs typically lease their properties to end users and may concentrate on a market segment, such as office, retail, commercial or industrial properties, high-end or middle-market segments, or a specific industry segment such as health care or malls or lodging. Mortgage REITs may also have a focus on particular types of loans (first mortgages, distressed property mortgages, mezzanine financings) or borrowers. Hybrid REITs are relatively rare and own a combination

2016	Three REIT IPOs raised approximately $1.6 billion of gross proceeds
2017	Nine REIT IPOs raised approximately $2.9 billion of gross proceeds

Source: NAREIT®.

Mortgage REITs

Mortgage REITs are playing a critical role in enhancing residential and commercial real estate liquidity, particularly in light of continuing dislocation in the primary and secondary mortgage markets since the Great Recession. As such, the number of publicly traded mortgage REITS has grown from 26 at the beginning of 2011 to 41 at December 31, 2017 (Source: NAREIT®). Mortgage REITs must comply with all of the requirements applicable generally to REITs, which we describe in this Guide, and also must satisfy additional conditions. Mortgage REITs rely on the Section 3(c)(5)(C) exemption from registration under the Investment Company Act of 1940 ("Investment Company Act"), which generally excludes from the definition of investment company any person who is primarily engaged in, among other things, "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." In order to qualify for this exemption, a mortgage REIT must comply with strict asset tests, including having at least 55% of its assets consist of mortgages and other liens on, or interests in, real estate that are the functional equivalent of mortgage loans (including certain mortgage-backed securities), referred to as "qualifying assets," and at least 80% of its assets consist of qualifying assets and real estate-related assets. Over time, the Staff of the SEC has provided guidance in the form of no-action letters regarding the types of securities that it would deem to be qualifying assets. The SEC closely monitors reliance by mortgage REITs on this exemption.

There are potential regulatory risks for mortgage REITs. Due principally to the SEC's concerns regarding the use of leverage by mortgage REITs, in August 2011, the SEC issued a Concept Release (Release No. IC-29778) to solicit public comment on whether mortgage REITs should be regulated as investment companies subject to the Investment Company Act. This would subject mortgage REITs to numerous operating restrictions, including leverage limits. Many mortgage industry participants, including the Mortgage Bankers Association and the National Association of Real Estate Investment Trusts ("NAREIT"), commented unfavorably on the Concept Release. On February 12, 2018, in no-action relief granted to a mortgage REIT, the SEC Staff acknowledged that the real estate finance business has evolved substantially since the enactment of the Investment Company Act, with the creation and use of new debt financing techniques and mortgage-related products. In the relief, the Staff indicated that a particular issuer's assets, sources of income, historical development, public representations of its policy, and the activities of its officers, directors and employees (and other relevant factors) may indicate that the issuer is primarily engaged in the real estate finance business and, therefore, should be able to rely on the Section 3(c)(5)(C) exclusion. This principles-based grant of relief focuses on the business activities of a particular issuer, instead of whether a particular asset is a qualifying asset, in determining the availability of the Section 3(c)(5)(C) exemption. Mortgage REITs will need to obtain confirmation from the SEC Staff during the initial public offering comment period on the particular issuer's business activities prior to commencing a public offering.

In addition, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2012 ("Dodd-Frank Act") amended the Commodity Exchange Act to add a definition of "commodity pool" under Section 1a(10), which provides that any investment trust, syndicate or similar form of enterprise operated for the purpose of trading in commodity interests is a commodity pool. Commodity interests now include swaps. Prior to the Dodd-Frank Act, the U.S. Commodity Futures Trading Commission ("CFTC") had issued no-action relief to the directors of mortgage REITs using futures and options to mitigate interest rate risk. As mortgage REITs use swaps in the ordinary course of business, these provisions and the related CFTC rules raised concerns that mortgage REITs could be regulated as "commodity pools." In response to numerous requests for relief, in December 2012, the CFTC's Division of Swap Dealer and Intermediary Oversight issued an interpretive letter (CFTC Letter No. 12-44) that mortgage REITS were, in fact, commodity pools, but that the CFTC would not take enforcement action against the operator of a mortgage REIT if it did not register as a commodity pool operator if it satisfies enumerated conditions. Relatedly, given that commodity pool operators are considered "financial entities" under the Dodd-Frank Act, mortgage REITs would not be considered end-users for purposes of the regulatory framework for derivatives and would not be able to claim an exception from the clearing requirement for their swaps.

of equity and mortgage interests in real property. At December 31, 2017, there were 181 equity REITs with equity market capitalization of $1.07 trillion and 41 mortgage REITs with equity market capitalization of $67.75 billion (Source: NAREIT®).

Investment Company Act

The Investment Company Act is the primary source of regulation for open-end mutual funds, unit investment trusts, closed-end funds, and other investment companies. Section 3(c)(5)(C) of the Investment Company Act exempts from registration as an investment company any entity that is primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. The exemption has been interpreted by the SEC Staff to apply if at least 55% of the REIT's assets are comprised of "qualifying assets" and at least 80% of its assets are comprised of qualifying assets and real estate-related assets. The SEC Staff has given guidance from time to time through no-action letters regarding the types of assets that are "qualifying assets."

ADVANCE PLANNING

Most companies must make legal and operational changes before proceeding with an IPO. A company cannot wait to see if its IPO is likely to be successful prior to implementing most of these changes. Many corporate governance matters (including those arising under the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley")) and federal securities law requirements, as well as applicable securities exchange requirements, must be met when the IPO registration statement is filed, or the issuer must commit to satisfy them within a set time period.

A company proposing to list securities on an exchange should review the governance requirements of each exchange, as well as their respective financial listing requirements, before determining which exchange to choose. A company must also address other corporate governance matters, including board structure, committees and member criteria, related party transactions, and director and officer liability insurance. The company should undertake a thorough review of its compensation scheme for its directors and officers as well, particularly its use of stock-based compensation.

Most public REITs are organized in Maryland as either a corporation or a trust because Maryland has a special REIT law and is perceived as business-friendly to REITs. This is in contrast to operating companies, which typically incorporate in Delaware if they are preparing for an IPO.

See "UPREITs and Roll-ups" for an introduction to complex issues involved in forming a REIT, particularly if the REIT is created by combining multiple separate real estate holding entities. The SEC has extensive guidance on the disclosure and accounting requirements for these formation transactions.

Primary and Secondary Offerings

An IPO may consist of the sale of newly issued shares by the company (a "primary" offering), a sale of already issued shares owned by shareholders (a "secondary" offering), or a combination of these. Underwriters may prefer a primary offering because the company will retain all of the proceeds to advance its business. However, many IPOs include secondary shares, either in the initial part of the offering or as part of the 15% over-allotment option to purchase

UPREITs and Roll-ups

UPREITs

The most common operating structure for publicly traded equity REITs is the UPREIT structure. In the typical UPREIT, the partners of partnerships holding real estate assets and a new REIT become partners in a new partnership termed the Operating Partnership. For their respective interests in the Operating Partnership ("Units"), the partners contribute the real estate assets owned by them or their interests in the entities that own such real estate assets, and the REIT contributes the cash proceeds from its public offering. The REIT typically is the general partner and the majority owner of the Units. The allocation of the Units based on the properties being contributed can involve significant analysis and negotiation. The UPREIT structure allows tax deferral while providing a kind of "on demand" liquidity. After a period of time (typically one year), the partners may enjoy the same liquidity as the REIT shareholders by tendering their Units for either cash or REIT shares (at the option of the REIT or Operating Partnership). This conversion may result in the partners incurring the tax deferred at the UPREIT's formation. The unitholders may tender their Units over a period of time, thereby spreading out such tax. In addition, when an individual partner holds the Units until death, the estate tax rules usually permit the beneficiaries to tender the Units for cash or REIT shares without paying income taxes.

ROLL-UPs

A REIT can either acquire a property or mortgage loan or other real estate asset directly or through a "roll-up" process in which the REIT acquires the entities (partnerships or limited liability companies) that own the real estate asset in exchange for securities of the REIT or its Operating Partnership. As noted above, the UPREIT structure provides tax deferral advantages. From the securities side of the transaction, the question is whether the REIT is conducting an offering of its securities to the holders of the interests in the entities. The REIT could effect the roll-up transaction as a registered offering separate from the IPO. However, this approach is not typical, as registering a roll-up involves significant time and expense. The more common process is one or more private placements by the REIT to the holders of the assets. This process requires careful structuring, and, in the past, the private placement process had to be essentially complete before the IPO was publicly filed. The concern was that the private offering of the Units in a roll-up transaction could be integrated with the REIT IPO and could lead to application of the SEC roll-up rules (as discussed below) and securities liability for failure to register the Units.

In the late 1980s and early 1990s, in response to concerns about sponsor abuses in structuring public real estate

Non-Traditional REITs

In recent years, there has been some "modernization" with respect to what constitutes "good" REIT assets under the Internal Revenue Code of 1986, as amended (the "Code"). Through private letter rulings, the Internal Revenue Service ("IRS") has approved as good REIT assets certain assets not traditionally associated with the REIT structure such as data centers, timber, document storage facilities, cell-phone towers, casinos, private correctional facilities, and billboards. Because of the tax benefits of a REIT and the growing market for dividend-paying securities in a low-yield environment, there has been an increase in interest in REIT conversions by corporations. However, due to the requirements to qualify as a REIT and to maintain REIT status discussed above, converting into a REIT is a complicated process and requires careful consideration and significant restructuring.

On August 31, 2016, the Treasury Department published final regulations (the "Final Regulations") adopting many of the non-traditional REIT assets described above as good REIT assets for purposes of the REIT rules. The IRS had previously imposed a moratorium on issuing private letter rulings concerning the definition of "real property" prior to the issuance of its proposed regulations (the "Proposed Regulations") concerning the same on May 14, 2014. The Final Regulations predominantly adopted the Proposed Regulations with only slight modifications. As did the Proposed Regulations, the Final Regulations flesh out the definition of "real property" contained in regulations promulgated in 1962 to include the types of property for which the IRS previously provided favorable private letter rulings as described above. The Final Regulations define "real property" to include land, inherently permanent structures and structural components, specify certain assets that are per se "real property" for purposes of the REIT rules and adopt a framework using a facts and circumstances approach to determine whether other assets are real property. This guidance rollups, the U.S. Congress and California passed specific roll-up legislation, the SEC issued targeted roll-up disclosure requirements, and the National Association of Securities Dealers (now the Financial Industry Regulatory Authority, or "FINRA") issued roll-up guidelines, all of which were designed both to give investors necessary information about the transaction and to lessen the coercive effects of the offering. The SEC definition of a "roll-up transaction" has specific exclusions that often now are relevant. But if the exclusions are not applicable, in addition to the requirements of Form S-11 and SEC Industry Guide ("Guide 5"), the SEC will require significant additional disclosure, including about the properties being contributed (including separate supplements for each partnership), additional risk factors and disclosures regarding conflicts of interest, statements as to the fairness of the transaction to the investors in the partnerships, including whether fairness opinions are being rendered, explanation of the allocation of the roll-up consideration, and pro forma financial information.

If the transaction is a limited partnership roll-up, in addition to the requirements of Form S-11 and Guide 5, Section 14(h) of the Securities Exchange Act of 1934, as amended ("Exchange Act") and Items 902 through 915 of Regulation S-K will require significant additional disclosure on an overall and per partnership basis, addressing changes in the business plan, voting rights, form of ownership interest, the compensation of the general partner or another entity from the original limited partnership, additional risk factors, conflicts of interest of the general partner, and statements as to the fairness of the proposed roll-up transaction to the investors, including whether there are fairness opinions, explanations of the allocation of the roll-up consideration (on a general and per partnership basis), federal income tax consequences, and pro forma financial information.

There have been few public roll-up transactions in recent years, and most roll-up transactions currently are conducted as private placements, particularly following the SEC's 2007 interpretive guidance (Release No. 33-8828) on public/private integration issues. The rules promulgated under the Jumpstart Our Business Startups Act ("JOBS Act") that allow general solicitation and advertising in certain private securities offerings under Rule 506 and Rule 144A so long as the securities are sold to accredited investors or qualified institutional buyers ("QIBs") also lessen the securities law integration risk.

Any roll-up transaction, whether or not it meets the SEC and FINRA definitions, will have complex accounting and structuring issues that must be addressed with the accountants and counsel early in the IPO planning process, including relating to predecessor presentation and *pro forma* issues.

should be welcome for REITs because a taxpayer cannot rely on a private letter ruling received by another taxpayer.

On December 15, 2015, the Protecting Americans from Tax Hikes Act (the "PATH Act"), which generally prohibits REIT tax-free spinoffs by non-REIT entities, was enacted. The PATH Act bans corporations from electing REIT status within 10 years of being spun off and eliminates the tax-free treatment of REIT spinoffs, except in transactions where (i) one REIT spins off another REIT or (ii) in some cases, where the corporation spun off is a taxable REIT subsidiary ("TRS"). On June 7, 2016, the Treasury Department issued temporary regulations that further expand the scope of the PATH Act.

Internally or Externally Managed REITs

A REIT can be either internally or externally managed. In a REIT with an internal management structure, the REIT's own officers and employees manage the portfolio of assets. A REIT with an external management structure usually resembles a private equity style arrangement, in which the external manager receives both a flat fee and an incentive fee for managing the REIT's portfolio of assets. The external manager provides day-to-day management of the REIT's operations, a senior management team, and appropriate support personnel. There is a continuing debate over which management method best serves shareholder interests. The controversy has centered on which method of management produces higher returns for investors, with some arguing that conflicts of interest underpinning compensation arrangements for external managers create incentives that may not be aligned with the interests of shareholders. Generally, the flat fee that an external manager receives is based on the asset value under management, which may create an incentive on the manager's part to purchase assets and incur leverage, while the incentive fee is based on income, total shareholder return, or the sale of assets.

Non-Traded REITs

Non-traded REITs are REITs whose common stock is registered under the Securities Act of 1933, as amended (the "Securities Act"), but is not traded on a national securities exchange. A non-traded REIT's securities usually have a limited secondary market, and their value does not typically change with the market. Because a non-traded REIT does not have to satisfy the earnings and capitalization requirements of an exchange, they are particularly useful in blind pool capital raises where the specific real properties to be acquired are identified after the capital raise based on a predetermined investment strategy. Therefore, the reputation and past experience of the sponsor or the general partner is critical in such cases because an investor will make investment decisions based on that information. Additionally, offerings for non-traded REITs usually are done on a best-efforts basis.

In August 2012, FINRA alerted investors about the greater risks associated with non-traded REITs than traded REITS, noting the following risks:

- Distributions are not guaranteed and may exceed operating cash flow.
- Lack of a public trading market creates illiquidity and valuation complexities.
- Early redemption is often restrictive and may be expensive.
- High front-end fees that can be as much as 15% of the per share price.

The SEC Staff has also expressed concern about the valuation of non-traded REITs and has also issued guidance regarding distributions, dilution, redemptions, disclosures, and estimated value per share.

On April 11, 2016, FINRA adopted amended rules that changed the way that the per share value of a non-traded REIT is reported on its customer account statement in an effort to increase transparency. Statements can now either list the purchase price less any fees or commissions or sponsors can list an appraised value of the security. Previously, it was common for statements to only show a gross purchase price. Additionally, appraised value must be based on a third-party annual valuation of the non-traded REIT's underlying assets.

additional shares granted to underwriters. An issuer must also consider whether any of its shareholders have registration rights that could require it to register shareholder shares for sale in the IPO or thereafter, affecting the aftermarket for the shares.

Governance and Board Members

A public company must comply with significant corporate governance requirements imposed by the federal securities laws and regulations and the regulations of the applicable exchanges, including with regard to the oversight responsibilities of the board of directors and its committees. A critical matter is the composition of the board itself. All exchanges require that, except under limited circumstances, a majority of the directors be "independent," as defined by both the federal securities laws and regulations and exchange regulations. In addition, boards should include individuals with appropriate financial expertise and relevant real estate industry experience, as well as an understanding of risk management issues and public company experience. A company should begin its search for suitable directors early in the IPO process even if it will not appoint the directors until after the IPO is completed. The company can turn to its large investors as well as its counsel and underwriters for references regarding potential directors.

THE OFFERING PROCESS

The public offering process is divided into three periods:

- **The pre-filing period** between determining to proceed with a public offering and the actual SEC filing of the registration statement; the company is in the "quiet period" and subject to potential limits on public disclosure relating to the offering.

Emerging Growth Companies ("EGCs")

The April 2012 JOBS Act amended the Securities Act and Exchange Act to include a new type of issuer called an emerging growth company (an "EGC"). An issuer qualifies as an EGC if it has a total gross revenue of less than $1.07 billion (originally $1 billion, but amended for inflation in 2017) during its most recently completed fiscal year subject to inflationary adjustment by the SEC every five years. An issuer will not be able to qualify as an EGC if it first sold its common stock in an SEC-registered offering before December 8, 2011.

A company that elects to file as an EGC would benefit from the following:

- Confidential submission of the draft IPO registration statement to the SEC for nonpublic review (See "The Pre-Filing Period" below);
- Disclosure of only two years of audited financials (instead of three);
- No requirement to include financial information in selected financial data or in Management's Discussion and Analysis ("MD&A") disclosure for periods before those presented for the IPO;
- Option to rely on certain scaled disclosures available to smaller reporting companies (such as for executive compensation);
- Ability to test-the-waters with QIBs and institutional accredited investors to gauge interest before or after filing (See "The Pre-Filing Period" below);
- Exemption from:
  - The advisory vote on golden parachute payments;
  - Disclosing the relationship between executive compensation and financial performance;
  - Disclosing CEO pay-ratio;
  - Auditor attestation of internal controls under Section 404 of Sarbanes-Oxley;
  - Compliance with new or revised accounting standards until the date the standard becomes broadly applicable to private companies; and
  - Any Public Company Accounting Oversight Board rules requiring audit firm rotation or modified audit report requirements unless the SEC determines it is necessary.
- Phase-in of say-on-pay requirement:
  - In the case of an issuer that was an EGC for less than two years, by the end of the three-year period following its IPO; and
  - For any other EGC, within one year of having lost its EGC status.

An issuer will remain an EGC until the earliest of:

- The last day of the first fiscal year after the issuer's annual revenues exceed $1.07 billion;
- The last day of the fiscal year following the fifth anniversary of the issuer's IPO;
- The date on which the issuer has, during the previous three-year period, issued more than $1 billion in non-convertible debt; and
- The date on which the issuer qualifies as a large accelerated filer.

Reg A Offerings for REITs

In June 2015, the final rules implementing the Title IV of the JOBS Act became effective. These rules provide an exemption for U.S. and Canadian companies that are not required to file reports under the Exchange Act to raise up to $50 million in a twelve-month period in Regulation A offerings. The rules create two offering tiers: Tier 1 for smaller offerings raising up to $20 million in any twelve-month period and Tier 2 for offerings raising up to $50 million. The rules modernize the Regulation A framework by, among other things, requiring that disclosure documents be filed on EDGAR, allowing an issuer to make a confidential submission with the SEC, permitting test-the-waters communications, and disqualifying bad actors. The rules impose different disclosure requirements for Tier 1 and Tier 2 offerings, with more disclosure required for Tier 2 offerings, including audited financial statements. Tier 1 offerings are subject to both SEC and state blue sky pre-sale review. Tier 2 offerings are subject to SEC, but not state blue sky pre-sale review; however, investors in Tier 2 offerings are subject to investment limits (except when securities are sold to accredited investors or are listed on a national securities exchange). Following the completion of the Regulation A offering, Tier 2 issuers are required to comply with periodic filing requirements, which include a requirement to file current reports upon the occurrence of certain events, semi-annual reports and annual reports. A Tier 2 issuer may concurrently list a class of securities on a national exchange through a short-form Form 8-A, without filing a separate registration statement on Form 10. Regulation A offerings have proven to be a popular capital-raising alternative for real estate related companies, including REITs. Of the 307 qualified Regulation A offerings as of December 31, 2017, 35 were REITs and 79 were real estate related businesses that did not intend to qualify as REITs.

- **The waiting or pre-effective period** between the SEC filing date and the effective date of the registration statement; during this period, the company may make oral offers, but may not enter into binding agreements to sell the offered security.
- **The post-effective period** between effectiveness and completion of the offering.

The Registration Statement

A registration statement contains the prospectus, which is the primary selling document, as well as other required information, written undertakings of the issuer, and the signatures of the issuer and the majority of the issuer's directors. It also contains exhibits, including basic corporate documents and material contracts. For REITs and certain other issuers whose businesses are primarily that of acquiring and holding real estate or interests in real estate, the SEC requires that the issuers use Form S-11 for IPOs as well as Guide 5. Note, issuers that operate a real estate-related business, such as a resort, are considered to be providing a service rather than holding real estate and must file on Form S-1. Foreign private issuers may also use Form S-11, although they are permitted to comply with certain provisions of Form 20-F, the general registration form for foreign private issuers, for certain non-real

TAXING THOUGHTS

In general, a REIT is able to offer publicly traded equity-taxed interests through an IPO without altering the tax treatment of the REIT. The issuer and underwriter will need to perform a substantial amount of due diligence to confirm that the issuer is and will be eligible to be taxable as a REIT, including confirmation that the issuer will satisfy the asset and income tests and the distribution requirements and will not engage in any prohibited transactions. The issuer will also be required to satisfy a number of technical requirements such as having at least 100 shareholders. If the issuer qualifies as a REIT, its income generally will not be subject to tax at the REIT level. Instead its shareholders generally will be taxed on amounts distributed by the REIT. Ordinary REIT dividends are generally taxable to domestic shareholders as ordinary income. However, individual REIT shareholders are generally allowed to deduct 20% of the aggregate amount of ordinary dividends distributed by a REIT, subject to certain limitations, which may reduce the effective tax rate for individuals on the receipt of such ordinary dividends.

In order to maintain REIT qualification, a REIT must satisfy several tests regarding the nature and value of its assets. Generally, these tests must be satisfied at the end of each calendar quarter of each tax year of the REIT, subject, in certain circumstances, to a 30-day grace period. At least 75% of a REIT's assets must consist of "real estate assets" (such as ownership or leasehold interests in real property or mortgage), cash, cash items, and government securities. No more than 20% of the value of a REIT's total assets can consist of securities of a taxable REIT subsidiary (a "TRS"), which is a wholly owned subsidiary of a REIT that is taxed as a regular C corporation. No more than 5% of the value of the REIT's assets may consist of securities of any one issuer, other than a TRS, and a REIT may not hold more than 10% of the voting power of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer (other than a TRS).

At least 75% of a REIT's gross income must be attributable to real property, such as "rents from real property." In addition, at least 95% of a REIT's gross income must consist of income items qualifying for the estate-related disclosure rather than the more detailed requirements of Form S-11.

The Prospectus

The prospectus describes the offering terms, the anticipated use of proceeds, the company, its industry, business, management and ownership, and its results of operations and financial condition. Although it is principally a disclosure document, the prospectus also is crucial to the selling process. A good prospectus sets forth the "investment proposition."

As a disclosure document, the prospectus functions as an "insurance policy" of sorts in that it is intended to limit the issuer's and underwriters' potential liability to IPO purchasers. If the prospectus contains all SEC-required information, includes robust risk factors that explain the risks that the company faces, and has no material misstatements or omissions, investors will not be able to recover their losses in a lawsuit if the price of the stock drops following the IPO.

A prospectus should not include "puffery" or overly optimistic or unsupported statements about the company's future performance. Rather, it should contain a balanced discussion of the company's business, along with a detailed

75% income test as well as dividends, non-mortgage interest, and gain from sales of stock and securities. Thus, only 5% of a REIT's gross income can come from categories (such as service income) not qualifying for the 75% or 95% income tests.

In general, a REIT must make qualifying distributions equal to 90% of its taxable income in order to maintain its REIT qualification. A REIT can elect to retain its capital gains and pay tax on the gains, then treat the gains as if distributed to its shareholders, with the shareholders receiving a credit against their taxes for the tax paid by the REIT. Many REITs offer dividend reinvestment programs to their shareholders.

If a REIT engages in a prohibited transaction, the gains from that transaction are subject to a 100% tax. A prohibited transaction is the sale or other disposition of property held primarily for sale to customers in the ordinary course of business. REITs can avoid prohibited transactions by ensuring that any potential transactions meet certain "safe harbor" requirements.

In the process of converting from a corporation to a REIT, built-in gains with respect to assets transferred from the corporation to the REIT may be subject to tax. The direct or indirect transfer of property by a C Corporation to a REIT will cause the REIT to be taxable as a C Corporation on any net built-in gain of the property transferred to the REIT if such property is sold during the 5-year period following the date of transfer. However, the contributing C Corporation may make a deemed sale election pursuant to which it would be required to recognize its distributive share of the built-in gain on the date the property is transferred by the C Corporation to the REIT as if the property were sold for its fair market value. Similar rules may apply to a partnership that transfers property to a REIT if the partnership has direct or indirect corporate partners.

Careful tax planning is required to address these concerns.

RIDEA

The REIT Investment Diversification and Empowerment Act of 2007 ("RIDEA") was signed into law in July 2008, enabling health care REITs to structure their investments similar to hotel REITs. Rent received from a corporation in which a REIT owns 10% or more of the total voting power or total value of shares is excluded as "rent from property" under the income tests described above. Hotel REITs are exempt from this rule if they use an eligible independent contractor to manage the hotel facilities. After the enactment of RIDEA, health care REITs are similarly exempt.

discussion of risks and operating and financial trends that may affect its results of operations and prospects.

SEC rules generally require a substantial number of specific disclosures to be made in the prospectus. Most new REITs will qualify as EGCs and can take advantage of the scaled disclosure available for smaller public reporting companies. Further and in contrast to the general requirements of Form S-1, Form S-11 and Guide 5 contain detailed requirements regarding the following information for the issuer:

- real estate ownership
- investment policies
- operating data

DRESS REHEARSAL

Well before its IPO, an issuer should begin to approach executive compensation as would a public company. The IPO registration statement requires the same enhanced executive compensation disclosures that public companies provide in their annual proxy statements, including a discussion of compensation philosophy, an analysis of how compensation programs implement that philosophy, and a discussion of the effects of risk taking on compensation decisions. In mortgage REITs and REITs that are not self-managed or self-administered, the REIT will also be required to provide extensive disclosure of both the compensation paid to the managers and the process to manage conflicts of interest. Under the JOBS Act, an EGC is required to include only summary compensation information in the IPO registration statement rather than the more extensive discussion and analysis of compensation required for a non-EGC. However, an EGC should always keep in mind that it may be required to include more substantial executive compensation disclosure in future filings.

Issuers contemplating an IPO should consider:

Systematizing compensation practices. Compensation decisions should be made more systematically—doing so will require:

- establishing an independent compensation committee of the board of directors;
- using more formal market information to set compensation; and
- establishing a regular compensation grant cycle.

Confirming accounting and tax treatment. The issuer should be sure that the Internal Revenue Code ("Code") Section 409A valuation used to establish stock value for stock option purposes is consistent with that used for financial accounting purposes. The issuer also should consider whether to limit option grants as the IPO effective date approaches. Option grants close to an IPO may raise "cheap stock" issues.

Complying with securities laws. The issuer should confirm that equity grants were made in compliance with federal and state securities rules, including Rule 701 of the Securities Act limits, to avoid rescission or other compliance concerns.

Adopting plans. An issuer will have greater flexibility to adopt compensation plans prior to its IPO. Accordingly, planning ahead is essential. An issuer should adopt the plans it thinks it may need during its first few years of life as a public company (including an equity plan, employee stock purchase plans, and Code Section 162(m) "grandfathered" bonus plans) and reserve sufficient shares for future grants. Public companies are required to obtain shareholder approval for new compensation plans and material amendments.

Establishing a DRIP. Since REITs typically must pay dividends, in order to recapture a portion of such amounts and raise additional capital, many REITS adopt Dividend Reinvestment or Stock Repurchase Plans, or DRIPs.

THE MAGIC PAGE

The "Magic Page" is where a REIT discloses its dividend policy and distribution plans using a pro forma presentation that shows anticipated dividend payouts relative to cash available for distribution.

The SEC has provided several comments addressing acceptable content for the Magic Page, including the application of both U.S. Generally Accepted Accounting Principles ("GAAP") and non-GAAP financial measures. For more information about Non-GAAP financial measures, please see our publications, Non-GAAP Explained, Practice Pointers on Non-GAAP Financial Measures and Practice Pointers on Anticipating and Addressing SEC Comments on Non-GAAP Financial Measures.

- descriptions of the real estate
- disclosure about the prior experience of sponsors and their affiliates.

Depending on the nature of the specific REIT—UPREIT, DownREIT, equity, mortgage, externally managed, self-managed, or self-administered, blind pool, etc.—there will be additional necessary disclosures. If the transaction meets the SEC definition of a "roll-up transaction," there are further disclosure obligations (see "UPREITs and Roll-ups").

In addition, federal securities laws, particularly Rule 10b-5 under the Exchange Act, require that documents used to sell a security contain all the information material to an investment decision and do not omit any information necessary to avoid misleading potential investors. Federal securities laws do not define materiality; the basic standard for determining whether information is material is whether a reasonable investor would consider the particular information important in making an investment decision. That simple statement is often difficult to apply in practice.

Although the JOBS Act provides for certain reduced disclosure requirements for EGCs, an issuer should be prepared for a time-consuming drafting process, during which the issuer, investment bankers, and their respective counsel work together to craft the prospectus disclosure.

The Pre-Filing Period

The pre-filing period begins when the company and the underwriters agree to proceed with a public offering. During this period, key management personnel will generally make a series of presentations covering the company's business and industry, market opportunities, and financial matters. The underwriters will use these presentations as an opportunity to ask

Commodity Exchange Act and Equity REITs

According to a 2012 interpretative letter from the CFTC (CFTC Letter No. 12-13), an equity REIT is not a commodity pool, and therefore, is not subject to the Commodity Exchange Act if the equity REIT meets the following conditions:

- The primary income of the REIT comes from the ownership and management of real estate, and it only uses derivatives to mitigate exposure to interest rate or currency risk;
- The REIT complies with all the requirements of a REIT election under the Code, including the 95% and the 75% income test (Code Sections 856(c)(2) and 856(c)(3)); and
- The REIT has identified itself as an equity REIT in Item G of its last U.S. income tax return and continues to qualify as such or, if it has not filed its first tax return, it has expressed its intention to do so to its participants and effectuates such intention.

European Alternative Investment Fund Managers Directive

In the event that the shares in a REIT are intended to be offered or sold to any investor in a member state of the European Union, consideration needs to be given as to whether such offering or sale would be within the scope of the European Alternative Investment Fund Managers Directive ("AIFMD").

This directive will only apply where the REIT in question constitutes an alternative investment fund ("AIF"), as defined in the AIFMD. In many cases, a REIT may not constitute an AIF, but some REITs may qualify, making them potentially subject to European registration requirements.

An AIF is defined as a collective investment undertaking, including investment compartments thereof, (other than a retail-focused Undertaking for Collective Investment in Transferable Securities ("UCITS") fund, which is governed by separate legislation) which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors. All of these elements need to be present in order for the REIT to constitute an AIF. Many REITs will meet the collective investment undertaking and capital raising criteria under the AIF definition.

Therefore the key consideration for a REIT will be whether its capital is also invested in accordance with a defined investment policy and there is more detailed guidance from the European Securities and Markets Authority as to the factors that would tend to indicate the existence of such a defined investment policy.

Even if a REIT does constitute an AIF, there are complete exemptions available for internal funds, and there are also partial exemptions available for certain "small" managers of AIFs.

questions and establish a basis for their "due diligence" defense. In particular, underwriters will want to visit the major properties owned by property REITs as well as to analyze the mortgage loan portfolios of mortgage REITs. From the first all-hands meeting forward, all statements concerning the company should be reviewed by the company's counsel to ensure compliance with applicable rules. Communications by an issuer more than 30 days prior to filing a registration statement are permitted as long as they do not reference the securities offering. Statements made within 30 days of filing a registration statement that could be considered an attempt to pre-sell the public offering may be considered an illegal prospectus, creating a "gun jumping" violation. This might result in the SEC's delaying the public offering or requiring prospectus disclosures of these potential securities law violations. Press interviews, participation in investment banker-sponsored conferences, and new advertising campaigns are generally discouraged during this period.

However, the JOBS Act has softened the gun-jumping fears. If the company is an EGC under the JOBS Act, it can engage in oral and written test-the-waters communications with QIBs and institutional accredited investors to gauge interest in the offering during both the pre-filing period and after filing without being required to file written communications with the SEC. However, the SEC will ask to review copies of any written materials used for this purpose. Current market practice has been to use test-the-waters communications, which usually take place after the first confidential submission of the registration statement. An issuer should consult with its counsel and the underwriters before engaging in any test-the-waters communication.

In general, at least four to six weeks will pass between the distribution of a first draft of the registration statement and its filing with or submission to the SEC. To a large extent, the length of the pre-filing period will be determined by the amount of time required to obtain the required financial statements. An EGC may confidentially submit a draft registration statement for non-public review, but must file its registration statements publicly at least 15 days prior to conducting a roadshow. The confidential submission process allows an EGC to commence the SEC review process without publicly disclosing sensitive information and to work through the SEC comment process without the glare of publicity and without competitors becoming aware of the proposed offering. Further, should the issuer determine that the market will not be receptive to the offering, or that other alternatives are more appealing, it can withdraw from the process without the stigma of a failed deal. The confidentially submitted registration statement should be materially complete as the SEC might decide not to review an incomplete registration statement, slowing down the offering process.

Extension of SEC Policy on Confidential Submissions

In June 2017, the SEC's Division of Corporation Finance ("Corp Fin") announced a new policy effective July 2017 that essentially extends the confidential submission process to all issuers while keeping the EGC process unchanged. The SEC will review a draft initial registration statement under the Securities Act, and related revisions on a nonpublic basis. Similarly, the SEC also will now review a draft registration statement of a class of securities under Section 12(b) of the Exchange Act. The SEC will also accept draft registration statements submitted prior to the end of the twelfth month following the effective date of an issuer's initial

D&O Insurance

Directors' and officers' ("D&O") insurance protects directors and officers from losses resulting from their service to a company. Typically, a D&O insurance policy maintained by a private company will not provide coverage for securities offerings, such as an IPO, and will not contain the coverage or provisions applicable to public companies.

A company that is going public should review its existing D&O coverage and seek additional coverage. A public company's D&O insurance program generally contains three types of coverage in one policy:

- Side A covers D&Os' costs and expenses for defense and due to payouts under settlements and judgments, where indemnification may not otherwise be available, such as due to state law limitations.
- Side B provides reimbursement to the company if it has indemnified D&Os in connection with a claim. Side B coverage is the most commonly invoked portion of a D&O policy.
- Side C, known as "entity coverage," covers the company itself. For public companies, coverage usually includes only claims resulting from alleged securities law violations.

Insurance companies typically require companies seeking public company coverage to submit a complicated application and impose various compliance obligations upon the company once coverage is in place. False statements in the application or failure to comply with these obligations can result in the loss of coverage if any substantial liabilities arise. As a result, a company will want to be certain that it has one or more employees who have appropriate experience preparing the application and who will assume compliance responsibilities once the policy is effective. A company going public may also benefit from the guidance that a sophisticated and experienced insurance broker can provide, as the company (1) decides how to structure its D&O insurance program and (2) goes through the application process.

SEQUENCING KEY EVENTS

6–12 months before IPO

- Company rounds out management team (if needed)
- Focus on "corporate cleanup"
- Identify real estate assets that may be acquired

3–4 months before IPO

- Company decides formally to undertake IPO
- Appoint underwriter
- Publicity restrictions commence
- Finalize structure – UPREIT, DownREIT, etc.
- Analyze valuation of real estate assets
- Begin process to effect private roll-up transaction, if applicable

1 month before first SEC filing

- Conduct due diligence
- Complete prospectus drafting
- Complete audit and review of interim financials
- Adopt public company policies, controls, procedures, and other corporate governance matters if not already done
- Complete any private offering immediately prior to filing
- Conduct test-the-waters meetings

Initial SEC filing or confidential submission

- File Form S-11 with SEC or submit confidentially to SEC and submit application to exchange
- File confidential treatment request for any exhibits, if necessary
- Receive first SEC comments no more than 30 days after filing/submission
- File amended Form S-11, responding to second (and third and fourth) round of SEC comments, as necessary

Typically 2–3 months after first filing

- Resolve material SEC comments
- Listing approval
- Bulk print preliminary ("red") prospectus

15 days prior to road show

- File registration statement

Typically 1–2 weeks

- Road show

Transaction Effective

- Form S-11 declared effective
- Price deal

Commence public offering 3–4 days after pricing

- Close offering

Securities Act registration statement or an issuer's Exchange Act Section 12(b) registration statement for nonpublic review.

The Waiting Period

Responding to SEC Comments on the Registration Statement

The SEC targets 30 calendar days from the registration statement filing or confidential submission date to respond with comments. It is not unusual for the first SEC comment letter to contain a significant number of comments that the issuer must respond to both in a letter and by amending the registration statement. After the SEC has provided its initial set of comments, it is much easier to determine when the registration process is likely to be completed and the offering can be made. In most cases, offering participants delay the offering process and avoid distributing a preliminary prospectus until the SEC has received at least the first filing and all material changes suggested by the SEC Staff have been addressed.

Preparing the Underwriting Agreement, the Comfort Letter, and Other Documents; FINRA Filings

During the waiting period, the company, the underwriters and their respective counsels, and the company's independent auditor will negotiate a number of agreements and other documents, particularly the underwriting agreement and the auditor's "comfort letter."

NYSE vs. NASDAQ: Principal Quantitative Listing Requirements

The following table summarizes the principal quantitative listing requirements; there are also qualitative requirements. The overwhelming majority of REITs list on the NYSE.

SELECTED LISTING REQUIREMENT	NYSE	NASDAQ GLOBAL MARKET
Minimum Number of Shareholders	400 round lot holders	Same[1]
Minimum Number of Publicly Held Shares	1,100,000[2]	Same, with similar exclusions
Minimum Aggregate Market Value of Publicly Held Shares	$40 million	**Any of:** • $8 million under the Income Standard; • $18 million under the Equity Standard; or • $20 million under the Market Value Standard[3] or the Total Assets/Total Revenue Standard.[4]
Minimum Price per Share	At least $4.00 at initial listing	Same[5]
Minimum Number of Market Makers	N/A	Four, unless company qualifies for listing under the Income or Equity Standards, which each require three.[6]
Minimum Financial Standards	**One of the following:** • **Earnings Test:** Adjusted pre-tax earnings from continuing operations must total (1) $10 million for the last three fiscal years,[8] including a minimum of $2 million in each of the two most recent fiscal years and positive amounts in all three years, or (2) if there is a loss in the third fiscal year, $12 million for the last three fiscal years, including a minimum of $5 million in the most recent fiscal year and $2 million in the next most recent fiscal year;[9] or • **Global Market Capitalization Test:** $200 million in global market capitalization (existing public companies must meet the minimum global market capitalization for a minimum of 90 consecutive trading days prior to listing on the NYSE); or • **REIT Test:**[10] $60 million in stockholders' equity.	**One of the following:**[7] • **Income Standard:** (1) $1 million in annual pre-tax income from continuing operations in most recently completed fiscal year or in two of the three most recently completed fiscal years; and (2) stockholders' equity of $15 million; or • **Equity Standard:** (1) stockholders' equity of $30 million; and (2) two-year operating history; or • **Market Value Standard:** N/A for IPOs; or • **Total Assets/Total Revenue Standard:** total assets + total revenue of $75 million each for the most recently completed fiscal year or two of the three most recently completed fiscal years.

1. For the Nasdaq Global Select Market, at least 550 total holders and an average monthly trading volume over the prior 12 months of at least 1,100,000 shares; or at least 2,200 total holders; or a minimum of 450 round lot holders. For the Nasdaq Capital Market, a minimum of 300 round lot holders.
2. The number of shareholders includes shareholders of record and beneficial holders of shares held in street name. Shares held by directors, officers, or immediate families and other concentrated holdings of 10% or more are excluded.
3. Market Value Standard is not applicable to IPOs.
4. For the Nasdaq Global Select Market, $45 million. For the Nasdaq Capital Market, $15 million under the Equity or the Market Value of Listed Securities Standards and $5 million under the Net Income Standard.
5. For the Nasdaq Capital Market, $4 bid price or $2 closing price under certain conditions.
6. For the Nasdaq Capital Market, three.
7. The other tiers (Nasdaq Global Select Market and Nasdaq Capital Market) have different requirements.
8. Under certain circumstances, a company may qualify with $10 million in aggregate for two years and nine months.
9. A company that qualifies as an EGC and avails itself of the provisions of the Securities Act and the Exchange Act permitting EGCs to report only two years of audited financial statements can qualify under the Earnings Test by meeting the following requirements: Pre-tax earnings from continuing operations, as adjusted, must total at least $10 million in the aggregate for the last two fiscal years together with a minimum of $2 million in both years.
10. Only for REITs with less than three years of operating history.

The underwriting agreement is the agreement pursuant to which the company agrees to sell, and the underwriters agree to buy, the shares and then sell them to the public; until this agreement is signed, the underwriters do not have an enforceable obligation to acquire the offered shares. The underwriting agreement is not signed until the offering is priced. In a typical IPO, the underwriters will have a "firm commitment" to buy the shares once they sign the underwriting agreement. "Best efforts" offerings are rare for publicly traded REITs.

Underwriters' counsel will submit the underwriting agreement, the registration statement, and other offering documents for review to FINRA, which is responsible for reviewing the terms of the offering to ensure that they comply with FINRA requirements. In addition to compliance with the general FINRA corporate financing rule for IPOs, FINRA also imposes specific disclosure and organization and offering expense limitations on REIT offerings, which, for some purposes, are treated as "direct participation programs." However, REITs are exempt from FINRA Rule 2310 requirements regarding conflicts of interests. An IPO cannot proceed until the underwriting arrangement terms have been approved by FINRA.

In the "comfort letter," the auditor affirms:

(1) its independence from the issuer; and
(2) the compliance of the financial statements

SARBANES-OXLEY ACT OF 2002

Sarbanes-Oxley requires publicly traded companies to implement corporate governance policies and procedures that are intended to provide minimum structural safeguards to investors. Certain of these requirements are phased in after the IPO, and some requirements have been made less burdensome for EGCs under the JOBS Act.

Key provisions include:

- Requirements related to the company's internal control over financial reporting, including (1) management's assessment and report on the effectiveness of the company's internal controls on an annual basis, with additional quarterly review obligations, and (2) audit of the company's internal controls by its independent registered public accounting firm. However, a company will not need to comply with the auditor attestation requirement as long as it qualifies as an EGC.
- Prohibition of most loans to directors and executive officers (and equivalents thereof).
- Certification by the CEO and CFO of a public company of each SEC periodic report containing financial statements.
- Adoption of a code of business conduct and ethics for directors and senior executive officers.
- Required "real time" reporting of certain material events relating to the company's financial condition or operations.
- Disclosure of whether the company has an "audit committee financial expert" serving on its audit committee.
- Disclosure of material off-balance sheet arrangements and contractual obligations.
- Audit committee approval of any services provided to the company by its audit firm, with certain exceptions for *de minimis* services.
- Whistleblower protections for employees who come forward with information relating to federal securities law violations.
- Compensation disgorgement provisions applicable to the CEO and CFO upon a restatement of financial results attributable to misconduct.

The exchanges' listing requirements contain related substantive corporate governance requirements regarding independent directors, audit, nomination, and compensation committees, and other matters.

with applicable accounting requirements and SEC regulations.

The auditor also will note period-to-period changes in certain financial items. These statements follow prescribed forms and are usually not the subject of significant negotiation. The underwriters will also usually require that the auditor undertake certain "agreed-upon" procedures, which can be subject to significant negotiation, in which it compares financial information in the prospectus (outside of the financial statements) to the issuer's accounting records to confirm its accuracy.

Marketing the Offering

During the waiting period, marketing begins. The only written sales materials that may be distributed during this period are the preliminary prospectus, additional materials known as "free writing prospectuses," which must satisfy specified SEC requirements, and any EGC test-the-waters communications described above. While binding commitments cannot be made during this period, the underwriters will receive indications of interest from potential investors, indicating the price they would be willing to pay and the number of shares they would purchase. Once SEC comments are resolved, or it is clear that there are no material open issues, the issuer and underwriters will undertake a one to two week "road show," during which company management will meet with prospective investors. As noted above, an EGC must publicly file the confidentially submitted registration statement, along with any amendments, at least 15 days before the beginning of the road show.

Once SEC comments are cleared and the underwriters have assembled indications of interest for the offered securities, the company and its counsel will request that the SEC declare the registration statement "effective" at a certain date and time, usually after the close of business of the U.S. securities markets on the date scheduled for pricing the offering.

SEC Guidance

As discussed under "UPREITS and Roll-ups" elsewhere in this Guide, REIT formation transactions can be complex, resulting in significant accounting issues. The SEC is available to discuss these accounting and structuring issues even in advance of a confidential submission or filing of a registration statement, and it is advisable to approach the SEC early in the process to avoid costly delays.

The Post-Effective Period

Once the registration statement has been declared effective and the offering has been priced, the issuer and the managing underwriters execute the underwriting agreement, and the auditor delivers the final comfort letter. This occurs after pricing and before the commencement of trading on the following day. The company then files a final prospectus with the SEC that contains the final offering information.

On the third or fourth business day following pricing, the closing occurs, the shares are issued, and the issuer receives the proceeds. The closing completes the offering process. Then, for the following 25 days, aftermarket sales of shares by dealers must be accompanied by the final prospectus or a notice with respect to its availability. If during this period there is a material change that would make the prospectus misleading, the company must file an amended prospectus. This is referred to as the "quiet period."

THE UNDERWRITER'S ROLE

A company will identify one or more lead underwriters that will be responsible for the IPO. A company chooses an underwriter based on its industry expertise, including the knowledge and following of its research analysts, the breadth of its distribution capacity, and its overall reputation. A company should consider the underwriter's commitment to the sector and its distribution strengths. For example, does the investment bank have a particularly strong research distribution network, or is it focused on institutional distribution? Is its strength domestic, or does it have foreign distribution capacity? The company may want to include a number of co-managers in order to balance the underwriters' respective strengths and weaknesses.

A company should keep in mind that underwriters have at least two conflicting responsibilities—to sell the IPO shares on behalf of the company and to recommend to potential investors that the purchase of the IPO shares is a suitable and a worthy investment. In order to better understand the company—and to provide a defense in case the underwriters are sued in connection with the IPO—the underwriters and their counsel are likely to spend a substantial amount of time performing business, financial, and legal due diligence in connection with the IPO, visiting the properties, and making sure that the prospectus and any other offering materials are consistent with the information provided. The underwriters will market the IPO shares, set the price (in consultation with the company) at which the shares will be offered to the public, and, in a "firm commitment" underwriting, purchase the shares from the company and then re-sell them to investors. In order to ensure an orderly market for the IPO shares, after the shares are priced and sold, the underwriters are permitted in many circumstances to engage in certain stabilizing transactions to support the stock.

EGC Trends

Now that the JOBS Act is more than five years old, some trends in EGC IPOs have become apparent. Some EGCs are not taking full advantage of the various accommodations. In 2016:

- Approximately 83% of EGC IPOs have taken advantage of the confidential review process;
- Approximately 58% of EGC registration statements included only two years of audited financial statements and selected financial data (not including EGCs that are also smaller reporting companies or who do not have two years of reporting history); and
- Approximately 72% of EGC registration statements excluded a compensation discussion and analysis (not including EGCs that are also smaller reporting companies).

EGCs are taking advantage of the ability to use test-the-waters communications while broker-dealers are still generally not publishing research reports during the registration process or during the customary 25-day post-closing "quiet period." In addition, most REIT EGCs elect to comply with new or amended financial accounting standards.

In 2017, real estate companies accounted for 6.4% and 8.6% of EGC IPOs based on the number of IPO offerings and total dollar offering amount, respectively.

Source: CCH IPO Vital Signs

FINANCIAL REPORTING AND ACCOUNTING

The IPO registration statement must include audited financial statements for the last three fiscal years; financial statements for the most recent fiscal interim period, comparative with interim financial information for the corresponding prior fiscal period (may or may not be audited depending on the circumstances); and income statement and condensed balance sheet information for the last five years (the earliest two years may be derived from unaudited financial statements) and interim periods presented. The SEC also requires special income statement and balance sheet captions for REITs. A REIT may not be able to provide full financial statements with respect to real estate operations to be acquired. In those circumstances, the SEC may allow an issuer to include more limited financial information.

Early on, the issuer should identify any problems associated with providing the required financial statements (including any complex predecessor or similar issues in a "roll-up" IPO) in order to seek necessary accommodation from the SEC. These statements must be prepared in accordance with GAAP, as they will be the source of information for the MD&A. The SEC will review and comment on the financial statements and the MD&A. The SEC's areas of particular concern are:

- revenue recognition;
- business combinations;
- segment reporting;
- financial instruments;
- impairments of all kinds;
- deferred tax valuation allowances;
- compliance with debt covenants;
- fair value; and
- loan losses.

Additionally, an EGC may omit financial information for historical periods that otherwise would be required by Regulation S-X at the time of filing or submission, provided that the omitted financial information will not be required to be included in the registration statement at the time of the consummation of the offering and that, prior to distribution of a preliminary prospectus

The Dodd-Frank Act Wall Street Reform and Consumer Protection Act of 2010

The Dodd-Frank Act has led to additional corporate governance changes for public companies, including the following:

- On January 11, 2013, the SEC approved the rule changes of the NYSE and NASDAQ concerning a board's compensation committee practices and related disclosure. The new listing standards became effective on July 1, 2013, and they relate to:
  - a board's compensation committee practices and related disclosure;
  - issuer adoption of a policy providing for a "clawback" of incentive compensation from current and former executive officers if it is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws.
- Shareholder approval of certain transactions, including "say-on-pay" votes on executive compensation and certain golden parachute compensation arrangements.
- On July 1, 2015, the SEC proposed a rule that requires listed companies to implement clawback policies to recover incentive-based compensation received by current or former executive officers in the event of certain financial restatements.
- In August 2015, the SEC adopted rules requiring additional disclosure under Item 402 of Regulation S-K. Item 402(u) requires disclosure of the following for reporting companies starting with the first fiscal year beginning on or after January 1, 2017:
  (A) The median of the annual total compensation of all employees of the company, except the CEO;
  (B) The annual total compensation of the CEO; and
  (C) The ratio of the amount in (B) to the amount in (A), presented as a ratio in which the amount in (A) equals one, or, alternatively, expressed narratively in terms of the multiple that the amount in (B) bears to the amount in (A).

The disclosure requirements above do not apply to Smaller Reporting Companies, EGCs, investment companies, foreign private issuers, or Canadian filers under the U.S.–Canadian Multijurisdictional Disclosure System.

CONTROLLING YOUR SHARES – LOCK-UPS

To provide for an orderly market and to prevent existing shareholders from dumping their shares into the market immediately after the IPO, underwriters will require the issuer as well as directors, executive officers, and large shareholders (and sometimes all pre-IPO shareholders) to agree not to sell their shares of common stock, except under limited circumstances, for a period of up to 180 days following the IPO, effectively "locking up" such shares. Exceptions to the lock-up include issuances of shares in acquisitions and in compensation-based grants. Shareholders may be permitted to exercise existing options (but not sell the underlying shares), transfer shares to family trusts, and sometimes to make specified private sales, provided that the acquiror also agrees to be bound by the lock-up restrictions. These lock-up exceptions will be highly negotiated.

Note that, in an UPREIT structure, the unitholders may also be locked up but they may also be subject to a longer holding period before they can tender units for the securities of the public REIT.

In connection with an IPO, the issuer may want the option to "direct" shares to directors, officers, employees and their relatives, or specific other designated people, such as vendors or strategic partners. Directed share (or "family and friends") programs, or DSPs, set aside stock for this purpose, usually 5% to 10% of the total shares offered in the IPO. Participants pay the initial public offering price. Shares not sold pursuant to the DSP are sold by the underwriters.

Generally, directed shares are freely tradable securities and are not subject to the underwriter's lock-up agreement, although the shares may be locked up for some shorter period. Each underwriter has its own program format. There are, however, guidelines that must be followed. The DSP is not a separate offering by the company but is part of the plan of distribution of the IPO shares and must be sold pursuant to the IPO prospectus.

to investors, the registration statement includes all required financial statements. In August 2017, the SEC Staff issued guidance clarifying that an EGC may omit from its draft registration statements interim financial information that it reasonably believes it will not be required to present at the time of the offering, but interim financial information that will be included in a historical period that a non-EGC reasonably believes will be required to be included at the time of its first public filing may not be omitted from its filed registration statements.

The FAST Act

Under the Fixing America's Surface Transportation (FAST) Act, enacted in December 2015, an EGC can omit financial information for historical periods otherwise required to be submitted in its draft registration statement if it reasonably believes that such financial information will not be required at the time of the contemplated offering.

Measuring Performance

FFO

The real estate industry discloses a unique operating metric that the SEC traditionally has allowed. FFO, or "Funds from Operations," is neither operating income nor cash flow from operations. NAREIT has taken the lead in establishing a base definition of FFO since at least 1991, although many REITs disclose various forms of adjusted FFO. A typical FFO disclosure (from Vornado Realty Trust's Form 10-K for the year ended December 30, 2015), reflecting the SEC focus on the purpose of the metric and comparability, follows:

"FFO is computed in accordance with the definition adopted by the Board of Governors of the National Association of Real Estate Investment Trusts ("NAREIT"). NAREIT defines FFO as GAAP net income or loss adjusted to exclude net gains from sales of depreciated real estate assets and real estate impairment losses, depreciation and amortization expense from real estate assets, extraordinary items and other specified non-cash items, including the pro rata share of such adjustments of unconsolidated subsidiaries. FFO and FFO per diluted share are non-GAAP financial measures used by management, investors and analysts to facilitate meaningful comparisons of operating performance between periods and among our peers because it excludes the effect of real estate depreciation and amortization and net gains on sales, which are based on historical costs and implicitly assume that the value of real estate diminishes predictably over time, rather than fluctuating based on existing market conditions. FFO does not represent cash generated from operating activities and is not necessarily indicative of cash available to fund cash requirements and should not be considered as an alternative to net income as a performance measure or cash flows as a liquidity measure. FFO may not be comparable to similarly titled measures employed by other companies."

Other Performance Measures

Most REITs now disclose a variety of non-GAAP financial measures such as net operating income ("NOI"), cash/funds available for distribution ("CAD/FAD"), or adjusted funds from operations ("AFFO"). NOI is the operating income after operating expenses but before income taxes and interest are deducted. CAD/FAD is used to measure a REIT's ability to generate cash

Rule 144 Holding Period for OP Units

On March 14, 2016, the SEC Staff issued interpretative guidance with respect to the required Rule 144 holding period following the exchange of partnership interests in an umbrella operating partnership ("OP units") for shares of its parent REIT shares. Rule 144 provides a safe harbor from registration for the sale of restricted securities if certain conditions are satisfied, including a holding period requirement. The holding period requirement varies from six months to one year depending on whether the issuer has been subject to the reporting requirements of the Exchange Act during the preceding 90 day period. Generally, the holding period commences at the time a person acquires a security. However, the interpretative guidance clarifies that for purposes of Rule 144(d)(1), the holding period for REIT shares issued in transactions consistent with certain conditions commences upon the earlier acquisition of the OP units. The conditions noted in the interpretive guidance include the following: (i) the OP unit holders paid the full purchase price for the OP units at the time they were acquired from the umbrella operating partnership; (ii) an OP unit is the economic equivalent of a REIT share, representing the same right to the same proportional interest in the same underlying pool of assets; (iii) the exchange of REIT shares for OP units is entirely at the discretion of the parent REIT; and (iv) no additional consideration is paid by the OP unit holders for the REIT shares.

As a result of the interpretive guidance, registration rights may no longer be necessary in many OP unit transactions because holders generally will be able to immediately sell any REIT shares received upon redemption of OP units. However, OP unit holders may still want registration rights, particularly if a significant number of OP units are being issued and the holders want the right to sell their shares in an underwritten offering or "piggyback" on an underwritten offering by the REIT. If OP units are being issued to affiliates, those affiliates also may want registration rights because they will still be subject to the volume limitation and manner of sale requirements under Rule 144. In addition, the interpretive guidance is limited solely to the UPREIT structure, as the SEC Staff did not address the ability to tack the Rule 144 holding period in other transaction structures, such as the DownREIT structure.

and to distribute dividends and is equal to FFO minus recurring capital expenditures. AFFO is equal to FFO after adjustments for certain non-comparable items. Depending on the adjustments, the AFFO calculation varies from company to company, which can make a comparability analysis difficult.

Additionally, mortgage REITs may use other non-GAAP financial measures such as "core earnings" (or other similarly titled measures). Core earnings is typically defined as net income (loss) excluding realized and change in unrealized gains (losses), gains (losses) on financial derivatives, and any other non-recurring items of income (loss). Core earnings and similar metrics are typically useful for mortgage REIT investors because they assess a mortgage portfolio's performance by evaluating its effective net yield.

SEC Treatment of Non-GAAP Financial Measures

Regulation G requires issuers to include a reconciliation and general disclosure with respect to any non-GAAP financial measures that are publicly disclosed. The reconciliation requirement provides that whenever an issuer publicly discloses (whether in an SEC-filed report or in an earnings call or investor presentation) material information that includes a non-GAAP financial measure, it must accompany that non-GAAP financial measure with (i) a presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP and (ii) a quantitative reconciliation of the differences between the non-GAAP financial measure and the most directly comparable GAAP financial measure.

On May 17, 2016, the SEC staff issued updated Compliance and Disclosure Interpretations ("CD&Is") on the use of non-GAAP financial measures. The updated C&DIs included certain updates to the use of the FFO and AFFO performance metrics. The SEC staff stated that it continues to accept NAREIT's definition of FFO, as in effect as of May 17, 2016, as a performance measure and does not object to such presentation on a per share basis. The SEC staff also stated that a REIT may present FFO on a basis other than as defined by NAREIT (such as AFFO), provided that any adjustments made to FFO must comply with the requirements of Item 10(e) of Regulation S-K for a performance measure or a liquidity measure. Depending on the nature of the adjustments, if FFO is presented or adjusted as a liquidity measure, then the presentation of FFO/AFFO on a per share basis is prohibited.

For more information, see our publications Non-GAAP Explained and Practice Pointers on Non-GAAP Financial Measures.

Internal Control over Financial Reporting

An issuer will not be required to include either a management's report on its internal control over financial reporting or an auditor's report on such internal control until the second annual report following its IPO. However, so long as the company is an EGC under the JOBS Act, it will be exempt from providing an auditor's report on such internal control.

SEC COMMENTS

An integral part of the IPO process is the SEC's review of the registration statement. Once the registration statement is filed or confidentially submitted, a team of SEC Staff members is assigned to review the filing. The team consists of accountants and lawyers, including examiners and supervisors. The SEC's objective is to assess the company's compliance with its registration and disclosure rules.

The Process

The SEC's principal focus during the review process is on disclosure. In addition to assessing compliance with applicable requirements, the SEC considers the disclosures through the eyes of an investor in order to determine the type of information that would be considered material. The SEC's review is not limited to just the registration statement. The SEC Staff will closely review websites, databases, and magazine and newspaper articles, looking in particular for information that the staff thinks should be in the prospectus or that contradicts information included in the prospectus.

The review process is time-consuming. While there was a time when the review process could be completed in roughly two months, now, given the length of the prospectus and the complexity of the disclosure, it can take two to four months. This depends on the complexity of the company's business and the nature of the issues raised in the review process.

Initial comments on Form S-11 are provided in about 30 days—depending on the SEC's workload and the complexity of the filing, the receipt of first-round comments may be sooner or later. The initial letter for REITs typically runs about 10 to 30 comments, with a majority of the comments addressing accounting issues. The company and counsel will prepare a complete and thorough response. In some instances, the company may not agree with the SEC Staff's comments and may choose to schedule calls to discuss the matter with the SEC Staff. The company will file or confidentially submit an amendment revising the prospectus and provide the response letter along with any additional information. The SEC Staff generally tries to address response letters and amendments within 10 days, but timing varies considerably.

Frequent Areas of Comment

It is easy to anticipate many of the matters that the SEC will raise in the comment process. The SEC makes the comment letters and responses from prior reviews available on its website, so it is possible to determine the most typical comments raised during the IPO process.

Overall, the SEC Staff looks for a balanced, clear presentation of the information required in the registration statement. Some of the most frequent comments raised by the SEC Staff on disclosure, other than the financial statements, include:

- **Front cover and gatefold:** On the theory that "a picture is worth a thousand words," does the artwork present a balanced presentation of the company's business, properties, or geographies?
- **Prospectus summary:** Is the presentation balanced?
- **Risk factors:** Are the risks specific to the company and devoid of mitigating language? The following are risk factors as to which recent SEC comments have been issued:
  - Specificity of the risk factor heading;
  - Risks related to the manager such as internalization of management functions or difficulty in terminating or not renewing the manager for poor performance;
  - Conflicts of interests;
  - Liquidity events;
  - Distributions paid in excess of earnings and cash flow;
  - Material risks or expenditures in relation to lead paint with respect to properties;

- Any guarantee obligations in connection with related financing transactions;
- Change of investment strategy and financing strategy without shareholder approval; and
- Identification of material weakness in internal controls.

- **Use of proceeds:** Is there a specific allocation of the proceeds among identified uses, and, if funding acquisitions is a designated use, are acquisition plans identified?
- **Selected financial data and other financial information:** Does the presentation of non-GAAP financial measures comply with SEC rules?
- **MD&A:** Does the discussion address known trends, events, commitments, demands, or uncertainties, including the impact of the economy, trends with respect to liquidity, and critical accounting estimates and policies?
- **Business:** Does the company provide support for statements about market position and other industry or comparative data? Is the disclosure free of, or does it explain, business jargon? Are the relationships with customers and suppliers, including concentration risk, clearly described?
- **Management:** Is the executive compensation disclosure, particularly the compensation discussion and analysis, clear? Does it include discussion of performance targets, benchmarking, and individual performance?
- **Prior performance information:** Is the description of prior performance by related real estate entities complete, responsive to disclosure requirements, and balanced?
- **Underwriting:** Is there sufficient disclosure about stabilization activities (including naked short selling), as well as factors considered in early termination of lock-ups and any material relationships with the underwriters?
- **Exhibits:** Do any other contracts need to be filed based on disclosure in the prospectus?

A FINAL THOUGHT

While windows open and close, and REITs and their advisors may have different views concerning the right moment to commence active and intense preparation for an IPO, it is rarely too early to undertake the advance planning described above. Much of this preparatory work is neither time-consuming nor expensive. Yet it will enhance greatly the opportunity to get into the market quickly, when the market is there. And even if an IPO does not turn out to be the option of choice, this preparatory work should prove valuable in facilitating other funding opportunities, or even acquisition by an existing public company.

IPO ACCOMMODATIONS for EGCs

Available Accommodations	An EGC	A non-EGC
Confidential submission?	Yes, an EGC may submit its IPO registration statement to the SEC for confidential review as a result of JOBS Act provisions. Confidentiality is established by statute. *Securities Act Section 6(e)(2).*	New policy allows a non-EGC to submit its registration statement to the SEC for confidential review. A non-EGC must request confidential treatment for its submission under Rule 83.
When must registration statement be filed publicly?	15 days prior to commencement of a traditional roadshow.	15 days prior to commencement of a traditional roadshow.
Test-the-waters?	Yes.	No.
Disclosure accommodations?	Yes. These are discussed earlier under "EGC Accommodations."	No.
Financial information that may be omitted?	Confidential submissions may omit annual and interim financial statements that will not be required to be presented at the time of the offering.	In reliance on new guidance, confidential submissions may omit annual and interim financial statements that will not be required to be presented at the time of the first public filing.
Governance and other SOX-related accommodations?	Yes. These are discussed earlier under "EGC Accommodations."	No.

THE LIKELY ALTERNATIVES

A growing real estate company has a number of financing alternatives, in addition to a traditional firm commitment, underwritten IPO.

WHICH WAY TO GO?

PRIVATE CAPITAL RAISE/BANK LOAN

Benefits:
- Control
- Less or no dilution
- Less expensive and time-consuming
- No public obligations

Considerations:
- No acquisition "currency"
- Limits equity compensation
- Investor pressure for realization event
- No "public" profile or market following

PRIVATE SALE

Benefits:
- Can be complete realization event
- Avoids market instability
- No public obligations or expense

Considerations:
- Typically, no continuing involvement by management and founders
- May be time-consuming and expensive

DUAL-TRACK APPROACHES (IPO/PRIVATE SALE)

Benefits:
- Potential to maximize shareholder value
- More responsive to market conditions

Considerations:
- Unsuccessful sale could affect IPO valuation
- More time-consuming and expensive

ALTERNATIVE APPROACHES

Reverse Merger IPO (merger into a public shell)

Benefits:
- Combination IPO and sale
- Potentially faster than traditional IPO
- Can be combined with raising private capital
- Attractive to smaller private companies

Considerations:
- Has a bad reputation
- Need to find "clean" public shell
- Potential for unknown liabilities

Rule 144A IPO/"PIPO" (private IPO)

Benefits:
- SEC-style disclosure; no SEC review and delay
- Access to capital

Considerations:
- Limited to institutional investors
- Available only to certain industry sectors
- Delays but may not avoid public disclosure and other obligations

Regulation A+ Offering (with exchange listing)

Benefits:
- Provides IPO on-ramp
- Scaled SEC disclosure
- Attractive to smaller private companies

Considerations:
- Blue Sky exemption only for Tier 2 offerings (up to $50 million)
- Not available for certain companies (Exchange Act registrants, registered investment companies, business development companies, asset-backed issuers)

Spin-Off

Benefits:
- Unlocks perceived value of a business unit or subsidiary
- All benefits of being public

Considerations:
- Compliance with complex tax requirements and new restrictions
- Recent change in law generally prohibits REIT tax-free spin-offs by non-REIT entities
- SEC process is substantially similar to IPO
- All considerations of being public

NOTES:

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials in many areas. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology, and life science companies. We've been included on the *The American Lawyer's* A-List for 13 years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. Visit us at www.mofo.com.

Morrison & Foerster's REIT practice is a collaborative, integrated, multi-office practice involving capital markets, corporate, finance, M&A, investment management, real estate, tax, and other attorneys throughout the firm. Attorneys in the REIT practice area are actively involved in advising REITs and REIT sponsors, contributors, investors, investment advisers, underwriters, and institutional lenders on all aspects of REIT activity. Attorneys in the REIT practice area also have been active and influential in NAREIT and other industry organizations and in legislative affairs affecting the REIT industry. For more information on our REIT practice, refer to http://www.mofo.com/reits-services.

Because of the generality of this guide, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

Contributors:

Brian Hirshberg
(212) 336-4199
bhirshberg@mofo.com

Shiukay Hung
(212) 336-4331
shung@mofo.com

Remmelt A. Reigersman
(212) 336-4259
rreigersman@mofo.com

Anna T. Pinedo
(212) 468-8179
apinedo@mofo.com

Katherine Shaia
(212) 336-4179
kshaia@mofo.com

David P. Slotkin
(202) 887-1554
dslotkin@mofo.com

MORRISON | FOERSTER

mofo.com

twitter.com/thinkingcapmkts