

CAPITAL MARKETS DISRUPTOR: REAL ESTATE CROWDFUNDING IN THE UNITED STATES

Public REITs and other sponsors of real estate funds and projects have traditionally enjoyed the benefit of a broad range of choices to raise capital. Public REITs can obtain financing on a project-by-project basis or at the corporate level by means of public offerings or private placements, and REITs can also access capital as sponsors of their own opportunity funds or through strategic joint ventures. Similarly, private real estate sponsors have historically relied on a variety of nonpublic capital raising mechanisms at the property, joint venture or fund level. Each of these means offers unique advantages and disadvantages, and each figures prominently in the real estate investment landscape. However, that landscape is poised to be considerably disrupted by the advent of real estate crowdfunding, which can lower the cost of raising capital while offering a broader range of investment options.

1. Advantages of Real Estate Crowdfunding

Broadly speaking, by real estate crowdfunding, we mean raising capital through any platform that allows investors to make real estate investments by means of the internet. Despite its novelty, real estate crowdfunding has enjoyed rapid growth,¹ partly because it offers several logistical advantages over traditional methods of raising capital for real estate investments. Those advantages, which are discussed in further detail in *“The Future of Real Estate Crowdfunding”* by Christopher Mayer and David Sherman, are highlighted below:

Raising Capital from the General Public. As further explained below, crowdfunding platforms can now raise capital from the general public, not just from “accredited investors.” This development has expanded the pool of potential investors in commercial and residential real estate.

Disintermediation. In addition, a real estate crowdfunding platform can disintermediate “middlemen” who traditionally connect investors with investment

opportunities. Most public REITs and many private real estate sponsors rely on broker-dealers or placement agents in order to raise capital, and the fees charged for broker-dealers’ commissions and other up-front costs can be considerable. A real estate crowdfunding platform, on the other hand, may sponsor and sell its own deals (a “proprietary platform”) or may act as an intermediary for deals offered by third parties (a “multi-operator marketplace”). Examples of proprietary (or more recently hybrid) platforms include Fundrise, RealtyMogul and Broadstone, while Patch of Land and RealCrowd operate as multi-operator marketplaces. Both proprietary platforms and multi-operator marketplaces can lower transaction costs by operating without a broker-dealer.² However, internet platforms need to make up for the lack of a pool of investors that broker-dealers offer and rely heavily on marketing and social media to drive traffic to their websites.³

Individual Portfolio Creation. Real estate crowdfunding platforms can also offer a mechanism whereby investors can target investments and build their own portfolios.

For example, by accessing Real Crowd, Patch of Land or RealtyMogul, an investor can choose from a list of properties and development sites and fashion a portfolio of debt and/or equity investments that the investor deems suitable to its investment profile. When investing in a fund or a public REIT, on the other hand, investors typically gain exposure to a range of properties underwritten and selected by a professional manager, often across sectors and across geographies, but forego the ability to direct the investments that will be made. Crowdfunding platforms can therefore allow investors who are willing to rely upon their own property selection skills to gain targeted exposure to a particular asset or pool of assets without purchasing or financing the entire asset or pool. While a number of the established crowdfunding platforms have moved to a structure where capital is invested by the platform on a discretionary basis, we believe targeted investment platforms remain an important feature of the real estate crowdfunding landscape.

2. Cautionary Notes

Real estate crowdfunding is not all fun and games, however. Almost by definition, “crowdfunding” a real estate investment means that a sponsor takes in relatively small amounts of capital from a large number of investors, often individual “mom and pop” investors. This is a very different paradigm, say, from the traditional commercial real estate club deal. A crowdfunded deal likely involves more accounts and more back-office support than traditionally funded transactions. In addition, given the novelty of these mechanisms, crowdfunding deals may also initially bring with them uncharted regulatory issues and a greater risk of liability to the sponsor.⁴

Real estate sponsors thus need to be conscious that crowdfunding their projects means that traditional tools for exempting their offerings from securities regulations may no longer be available to them. We have seen our clients struggle (and succeed) when retooling their historical structures. This is because raising capital from a large number of investors over the internet raises issues under the Investment Company Act, the Advisers Act and broker-dealer regulations that did not arise when investors qualified as “qualified purchasers” or were limited in number.

In addition, while the disclosure requirements imposed on real estate crowdfunding platforms are generally less onerous than those imposed on registered public

offerings, antifraud liability provisions of federal and state securities laws, including Rule 10b-5, will still apply to sales of participating interests.

Consequently, market participants thus far see crowdfunding as better suited to opportunistic offerings of limited size and less well suited to major offerings to finance ground-up projects.

3. A Changing Regulatory Environment

The very notion of selling a security over the internet is itself a disruption of a longstanding legal order: since the passing of the Securities Act of 1933, it has been sacrosanct that securities offerings cannot be publicly marketed without first going through an arduous registration process with the Securities and Exchange Commission (SEC).

The possibility that an unregulated internet could be used to circumvent this cardinal rule prompted the SEC, through a series of no-action letters beginning in 1996,⁵ to try and harmonize the increasing popularity of the internet with the historical restriction on unregulated public offers and sales. Two recent developments have caused the use of crowdfunding as a tool to raise capital to grow. The first was the success of nonsecurities platforms such as Kickstarter and Indiegogo, which showed the power of the internet to raise capital. The second was the passage of the Jumpstart Our Business Startups Act (the JOBS Act) in 2012 and eventual implementation by the SEC of related rules and regulations.⁶

Rule 506(b)

Prior to implementation of the JOBS Act, online investment platforms conducted their offerings in reliance on the old Regulation D under the Securities Act, particularly Rule 506(b), and the procedures laid out in the SEC’s early no-action letters. These rules do not permit “general solicitation and general advertising” of any kind. Rather, in a traditional Rule 506(b) offering an investment platform may raise capital from “accredited investors”⁷ and up to 35 non-accredited investors. The investment platform must prescreen and establish a “pre-existing relationship” with these investors before being able to offer them its securities, and if the offering takes place on a website, the section of the website hosting offering materials and related investment options must generally be protected by a password.

Rule 506(c)

In the JOBS Act, Congress specifically mandated that the SEC adopt rules to permit general solicitation and general advertising in even nonregistered securities offerings. This “democratization” of the securities laws is reflected in new Rule 506(c) under Regulation D, which became effective on September 23, 2013. Rule 506(c) pointedly now permits wide public marketing of even nonregistered offerings, so long as all actual purchasers in the offering are accredited investors. Unlike Rule 506(b) offerings, however, a platform that engages in general solicitation and general advertising must take “reasonable steps” to verify that its investors are accredited investors prior to the sale of the security.⁸ Such “reasonable steps” may include nonmandatory methods included in Rule 506(c) such as written confirmation from a registered broker-dealer or a licensed attorney or the submission and review of tax returns or of bank statements. Alternatively, the platform may use a “principles-based methodology” and adapt its verification process to the particular facts and circumstances.⁹

We understand that most real estate crowdfunding platforms today continue to rely on the old Rule 506(b) procedures for their offerings. This is consistent with a general trend; from September 23, 2013, to December 31, 2015, issuances under 506(b) were significantly greater than issuances under 506(c) both by number of transactions and by total transaction volume.¹⁰ This is understandable – internet-sourced investors are typically reluctant to provide the detailed personal financial information necessary to comply with Rule 506(c)’s status verification rules (either because the information is difficult to assemble, requires effort beyond just “clicking” a box or is simply viewed as “none of your business”).

Regulation A+

The JOBS Act also required the SEC to adopt rules exempting offerings of up to \$50 million from the registration requirements of the Securities Act. This was implemented by the SEC with its adoption of a new and improved version of Regulation A (“Regulation A+”) that became effective on June 19, 2015. The adoption of Regulation A+ has proven to be a disruptor in its own right and has contributed to a changed landscape in online securities offerings. This is because qualifying issuers may now offer their securities to both accredited

and non-accredited investors without the necessity of qualifying their offerings under state “blue sky” laws.

Regulation A+ divides prospective offerings into two tiers: Tier 1 and Tier 2. To be eligible for either category, an issuer must meet certain requirements, including that the platform not be subject to the reporting requirements of the Securities Exchange Act of 1934 and that the platform not be an investment company under the Investment Company Act of 1940. A Regulation A+ issuer is required to file an offering statement with the SEC, which must contain basic prescribed information. While less onerous than the registration statement requirement for a registered offering, the offering statement is a detailed disclosure document that is subject to review and qualification by the SEC.

In a Tier 1 offering, the platform may offer up to \$20 million of securities in any rolling 12-month period. Tier 1 offerings, however, are subject to review both by the SEC and by state regulators under blue sky laws. Tier 2 offerings, on the other hand, permit issuers to raise up to \$50 million in any rolling 12-month period and are subject to SEC, but not to state blue sky, review. Consequently, we believe that Tier 2 offerings are more attractive to many issuers. Since June 15, 2015, 32 REIT or real estate companies have filed for a Regulation A+ offering. Nine of those filings have been pursuant to Tier 1, and 23 have been pursuant to Tier 2.¹¹

Importantly, a platform conducting a Tier 2 (or Tier 1) offering also need not engage in the onerous process of verifying whether investors are accredited. Due to the perceived advantages and flexibility of these new Tier 2 offerings, we now see some of the early adopters and prominent players in the real estate crowdfunding space, conducting offerings pursuant to Tier 2 of Regulation A+ instead of Rule 506(b), despite the initial ramp-up costs associated with the SEC qualification process.

4. Crowdfunded Investment Vehicles

Tier 2 offerings under Regulation A+ have already begun to facilitate what we believe is the next phase in real estate crowdfunding – the offering of pooled investment vehicles based on the reputation of the platform operator itself, rather than portals that simply connect investors with individual properties and projects offered by multiple sponsors. For example, Fundrise has offered two 2 “eREITs”™ to date that were fully

subscribed up to the \$50 million maximum under Tier 2 and it is sponsoring another three e-REITs that have been publicly filed and are in various stages of their offerings. RealtyMogul, another of the early multi-operator platforms to offer individual project investment opportunities, also recently launched its own pooled fund, MogulREIT, which, as of November 9, 2016, had raised approximately \$2.9 million. RichUncles has taken full advantage of the loosening of restrictions on advertising by launching extensive radio and television commercials featuring celebrity spokespeople to test the waters for its new pooled investment vehicle it appears likely to offer under Regulation A+.

5. Conclusion

In sum, real estate crowdfunding offers an exciting and potentially efficient additional method for REITs and other

private real estate sponsors to access capital. Raising large amounts of capital—in small increments from a broad audience in a short amount of time—is certainly a tempting proposition for public REITs and private real estate sponsors. As of the beginning of 2017, 174 offerings under Regulation A+ have been filed with the SEC and approximately 20% of the issuers that have taken advantage of Regulation A+ have been real estate companies.¹² Crowdfunding may not be poised to displace traditional capital raising methods entirely; it is particularly suited to opportunistic offerings of limited size and less well suited to major offerings to finance ground-up development projects.¹³ However, the capital markets are developing an additional mechanism to connect REITs and other real estate sponsors to investors with cash. In terms of the long-term outlook for real estate investing, we believe this is a good thing.

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End notes

¹ According to Massolutions, crowdfunding platforms raised approximately \$6.1 billion of capital online in 2013. By 2015, this figure was expected to rise to \$34 billion, of which approximately \$2.5 billion would be raised for investment in real estate assets.

² We note, however, that many sites affiliate with registered broker-dealers in order to enhance their ability to charge additional fees and/or provide operational flexibility.

³ See also "The Future of Real Estate Crowdfunding."

⁴ The use of social media advertising and other outlets such as blogs, tweets, etc. by crowdfunding platforms has been the subject of the SEC's recent review process and can be expected to be fertile ground for future regulatory concern.

⁵ IPOnet (July 26, 1996); Lamp Technologies, Inc. (May 29, 1997)

⁶ Congress' push to expand capital raising opportunities for smaller issuers also included "true" crowdfunding under Regulation CF, which became effective on May 16, 2016. Regulation CF, which caps offerings at \$1 million dollars and requires offerings to be conducted through registered portals, among other requirements, is beyond the scope of this article.

⁷ With respect to individual investors, accredited status generally means investors who have \$1 million in net worth (not including their primary residence) or \$200,000 in annual income for the prior 2 years (\$300,000 together with a spouse) and a reasonable expectation of reaching such income in the current year. The SEC has calculated that there are over 14 million such investors in the United States alone. See www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf.

⁸ Rule 506(c)(2)(ii)

⁹ <https://www.sec.gov/info/smallbus/secg/general-solicitation-small-entity-compliance-guide.htm>

¹⁰ <https://www.sec.gov/info/smallbus/acsec/private-securities-offerings-post-jobs-act-baughness-022516.pdf>

¹¹ Source: The Vintage Group, a division of PR Newswire

¹² Source: The Vintage Group, a division of PR Newswire

¹³ For a more fulsome discussion of the contexts to which real estate crowdfunding is suited, see "The Future of Real Estate Crowdfunding."

