

# SEC Issues Guidance Clarifying Rule 144(d)(1) Holding Period Requirements For REIT Shares Exchanged For Operating Partnership Units

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Untitled Document

On March 14, 2016, the staff of the SEC's Division of Corporate Finance issued a no-action letter (the "No-Action Letter") concluding that, for purposes of Rule 144 promulgated under the Securities Act of 1933, as amended (Rule 144) safe harbor, the holding period for shares of common stock of a publicly traded real estate investment trust (REIT) issued in exchange for privately placed units of limited partnership interest (OP Units) of the REIT's subsidiary operating partnership (the OP) commenced upon the acquisition of such OP Units. The March 2016 No-Action Letter, which was issued in response to a request submitted by Bank of America, N.A., Merrill Lynch, Pierce, Fenner & Smith Incorporated and three law firms seeking interpretative guidance (the "No-Action Request Letter"), addressed exchange transactions involving securities of a REIT and its OP organized in an umbrella partnership real estate investment trust (UPREIT) structure.

## Overview of Section 4(a)(1) and Rule 144 Safe Harbor

Section 5 of the Securities Act of 1933 (Securities Act) prohibits unregistered resales of "restricted securities," which are securities acquired directly or indirectly from an issuer (or an affiliate of the issuer) in a transaction or chain of transactions not involving any public offering, unless an exemption from registration applies. The most commonly used registration exemption for resales of restricted securities is Section 4(a)(1), which provides an exemption from registration for transactions by anyone other than an issuer, underwriter or dealer. Rule 144, which provides a safe harbor for compliance with Section 4(a)(1), states that a person meeting all the conditions of the rule will not be deemed a statutory underwriter, as defined under Section 2(a)(11) of the Securities Act and, thus, can rely on Section 4(a)(1) for the unregistered resale of his securities.

Among other conditions that must be satisfied to rely on Rule 144, a person selling restricted securities must meet the holding period requirements set forth under Rule 144(d)(1). The relevant Rule 144(d)(1) holding periods are as follows: (i) if the issuer (i.e., the "REIT") is, and has been for at least 90 days prior to the sale, subject to the reporting requirements of the Securities Exchange Act of 1934 (the "Exchange Act"), a minimum of six months must elapse between the date of the acquisition of the securities and any resale of such securities; and (ii) if the issuer (i.e., the "REIT") has not been subject to the reporting requirements of the Exchange Act for at least 90 days prior to the sale, a minimum of one year must elapse between the date of the acquisition of the securities and any resale of such securities.

### **UPREIT Structure**

As previously noted, the No-Action Letter addressed exchange transactions involving securities of a REIT and its OP organized as an UPREIT. In an UPREIT structure, all of the REIT's investments are acquired and owned directly or indirectly by the OP and all of its business is operated through such OP. The REIT's only material assets are the OP Units, with the REIT typically serving as or controlling the general partner of the OP. Other investors (Unit Holders) also own OP Units that are usually acquired in non-public offerings. OP Units typically are acquired by the Unit Holders in exchange for real estate assets contributed to the OP. It is also common for externally managed REITs to provide their advisors with long-term performance-based incentive compensation in the form of an operating partnership profits interest (LTIP Units) that, once fully vested and earned, may be converted into OP Units.

### **New Guidance**

The SEC concluded in the No-Action Letter that a Unit Holder's Rule 144(d)(1) holding period for shares of common stock of the REIT (REIT Shares) acquired upon an exchange of OP Units commences upon the Unit Holder's acquisition of the OP Units. In reaching its conclusion, the SEC emphasized the No-Action Request Letter's representations that the Unit Holders paid the full purchase price for the OP Units at the time they were acquired from the OP; 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; the exchange of REIT Shares for OP Units is entirely at the discretion of the REIT; and no additional consideration is paid by the Unit Holders for the REIT Shares.

***The No-Action Letter clarified an issue that was previously uncertain because the OP and the REIT are different issuers.***

## **Observations**

Prior to the issuance of the No-Action Letter, there was uncertainty and limited guidance as to whether the SEC would permit a Unit Holder that acquired REIT Shares in exchange for OP Units to tack on the holding period of the OP Units for purposes of Rule 144 or if the SEC would treat the REIT shares and OP Units as distinct securities of separate issuers and require the Rule 144(d)(1) holding period to restart upon the exchange. Accordingly, many REITs historically adopted a cautious approach by restarting the holding period upon the OP Unit exchange. The No-Action Letter will facilitate Rule 144 sales by Unit Holders of unregistered REIT Shares immediately upon their acquisition in exchange for OP Units. Notwithstanding satisfaction of the holding period requirements under the new guidance, issuer information, manner of sale, volume, and filing requirements continue to apply to affiliates of REITs seeking to rely on the Rule 144 safe harbor for resales of REIT Shares acquired in exchange for OP Units.

## **Caveats**

The guidance is limited to those structures that are the same as the one described in the No-Action Request Letter, which include the following features:

- All of the REIT's investments are acquired and owned directly or indirectly by its umbrella OP;
- The REIT conducts its business operations through the OP;

- The OP Units are the only material assets of the REIT and the REIT serves as the general partner of the OP (or controls the general partner);
- OP Units are also held by other investors, which were acquired in a non-public offering;
- One OP Unit is the economic equivalent of one REIT Shares (or such other fixed number of REIT Shares that maintains economic parity between the REIT Shares and OP Units);
- OP Units are substantially identical to REIT Shares in that they represent the same right to the same proportional interest in the same underlying pool of assets;
- The REIT Shares are registered under Section 12 of the Exchange Act and are publicly traded on a national securities exchange;
- There is no public market for OP Units and the OP's limited partnership agreement contains provisions that significantly restrict the transferability of the OP Units;
- Unit Holders must hold their OP Units for at least one year in order to request the OP redeem the OP units for cash or, in the REIT's sole determination, REIT Shares based on a fixed ratio that is adjusted to maintain economic parity between the REIT Shares and OP Units; and
- Unit Holders are not required to pay any additional consideration for the REIT Shares at redemption, and the cash value of the OP Unit at redemption directly corresponds to the REIT Share's market value at that time.

Accordingly, the SEC guidance in the No-Action Letter cannot be relied upon where the REIT's specific facts and circumstances differ from those set forth above in the No-Action Request Letter. Thus, it is unclear whether the holding period of the OP Units can be tacked onto the REIT Shares if the REIT Shares are registered pursuant to Section 12(g) of the Exchange Act, but not traded on an exchange, or if the OP Units were held for less than one year prior to being exchanged for REIT Shares. It is also uncertain, absent additional guidance, whether tacking of the holding period of the OP Units to the REIT Shares would be permitted in other REIT structures, such as where the REIT has assets in addition to its interest in the OP (i.e., a so-called "DownREIT" structure).

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