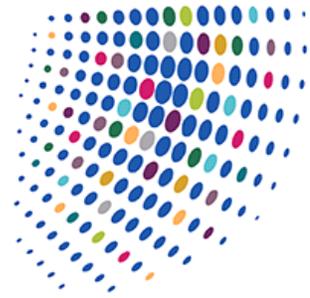


Alerts & Publications



SEC Issues Interpretive Guidance for BofA Regarding Resale of REIT Common Stock

April 1, 2016

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On March 14, 2016, the Securities and Exchange Commission's Division of Corporation Finance issued an interpretive letter to Bank of America, N.A., and Merrill Lynch, Pierce, Fenner & Smith Incorporated clarifying the application of Rule 144 under the Securities Act of 1933 to the resale of real estate investment trust ("REIT") common stock received upon the exchange of privately placed units in an UPREIT umbrella operating partnership ("OP Units"). The Division's letter to Bank of America Merrill Lynch, which we refer to herein as the BAML Letter, is available [here](#). The BAML Letter provides substantial benefits to holders of publicly traded REIT common stock received upon exchange of OP Units by permitting such holders to tack their holding period of the OP Units to their holding period of the REIT common stock. Some of these benefits provide practical advantages to holders of seasoned OP Units, even prior to conversion, because the BAML Letter's underlying analysis enhances the value and liquidity of OP Units as pledged collateral to potential lenders and hedging transaction dealers, and addresses Securities Act Section 5 concerns that had deterred pre-conversion hedging transactions referencing the REIT common stock. Although not covered by the BAML Letter, the same analysis may also be useful in other (non-REIT) situations involving economically equivalent securities. The staff issued the letter in response to a request submitted by Bank of America, N.A., Merrill Lynch, Pierce, Fenner & Smith Incorporated, and three law firms, including O'Melveny & Myers LLP.

Background: "UPREIT" Structure and Rule 144

The BAML Letter relates to an REIT structure, commonly referred to as an "UPREIT," in which the REIT's only material assets are OP Units in an umbrella operating partnership that directly or indirectly holds the REIT's real estate assets, and where the REIT either serves as the general partner of the operating partnership or controls the general partner. OP Units are also held by other investors that acquire the OP Units in non-public offerings, typically in exchange for real estate assets they contributed to the operating partnership. At the time the umbrella operating partnership is formed, the REIT conducts an initial public offering and has its common stock listed on a national securities exchange. In contrast, the OP Units are subject to contractual restrictions on transferability and are restricted securities for purposes of Rule 144. The operating partnership provides liquidity for OP Unit holders by permitting such holders to redeem their units, whereby the partnership redeems the OP Unit for cash, or the REIT, at its

sole option, may assume the redemption obligation and exchange the OP Units for REIT common stock. Because the REIT common stock represents the same right to the same proportional pool of real estate assets, the common stock is the economic equivalent of the OP Unit, and the cash value of the OP Unit at redemption is the market price of the REIT common stock at the time of redemption.

Rule 144 provides a safe harbor from registration under the Securities Act for sales of restricted securities, which are securities acquired from the issuer or an affiliate of the issuer in a transaction not involving a public offering. In order to rely on the safe harbor, securities must be held for at least six months after they have been fully paid for (or for at least one year if the securities are issued by a company that has been public for fewer than 90 days at the time of the sale). Under certain circumstances, a holder of restricted securities may combine (or “tack”) the holding period of other persons or related securities to the holding period of newly acquired securities. Before it issued the BAML Letter, the Division’s informal position was that an OP Unit holder could not combine the holding period of the OP Unit with the holding period of the REIT common stock. The BAML Letter reverses this position and makes clear that holders (including affiliates of the REIT) of REIT common stock received upon redemption of OP Units may include their holding period of the OP Units when selling the REIT common stock pursuant to the Rule 144 safe harbor. To take advantage of this new interpretive position, the transaction must comply with each of the following conditions:

- The OP Unit holder must have paid the full purchase price for the OP Units at the time the OP Units were acquired;
- The common stock must be the economic equivalent of the OP Unit, representing the same right to the same proportional interest in the same underlying pool of assets;
- The decision to exchange the OP Unit for common stock in lieu of cash must be entirely at the discretion of the issuer; and
- No additional consideration may be paid by the OP Unit holder for the shares of common stock.

Under these circumstances, the Division agreed that the holding period for the common stock received in exchange for OP Units begins on the date the OP Units were acquired. Because the parties submitting the request for relief did not identify specific parties or specific transactions, the Division’s letter represents an interpretive position upon which any holder of REIT common stock received in a covered exchange transaction should be able to rely.

Practical Legal Considerations

The BAML Letter reaffirms, confirms, and expands key aspects of the Rule 144 safe harbor. Some of the most important practical benefits of the BAML Letter include:

- Reaffirming that, under certain circumstances, the holding period for restricted securities may be deemed to have begun before the restricted security was acquired, as a matter of right pursuant to Rule 144(d)(1) and without reference to the specific tacking provisions of Rule 144(d)(3); in other words, reaffirming that holders of restricted securities may, under certain circumstances, tack their holding period upon an exchange of securities, notwithstanding the fact that the circumstances do not meet the requirements of any of the specific tacking provisions set out in Rule 144(d)(3);
- Confirming that the Rule 144(d)(1) holding period is intended to ensure that a holder of restricted securities has assumed the full economic risks of an investment, such that, upon an exchange of securities that does not result in any change in the economic risk of the investment, the relevant holding period may, under certain circumstances, be deemed to have begun at the time the exchanged security was acquired; and
- Providing clarity with respect to the application of the holding period requirement of Rule 144(d)(1) to circumstances involving the securities of different issuers, where the securities of both issuers represent the same proportionate right to the same underlying pool of assets.

Commercial Application

Although the BAML Letter is limited to the UPREIT structure described above, the principles underlying the interpretive position may support a similar result in a variety of transactions involving an exchange of economically equivalent securities. Therefore, the BAML Letter may be relevant to the assessment of similar corporate structures (including so-called “Up-C” structures, which also involve a public company whose only material assets are its investment in an operating partnership), as well as other transactions involving securities that represent the same proportional right to an underlying pool of assets. The BAML Letter may also facilitate the following specific transactions involving OP Units:

Elimination of Registration Rights

REITs often provide OP Unit holders with the right to require the REIT to register the issuance or resale of REIT common stock upon the conversion of OP Units. Such “registration rights” are customarily provided so that OP Unit holders may immediately sell or resell REIT common stock in order to satisfy certain tax obligations associated with the conversion of OP Units. Because such liquidity may now be obtained through public resales in reliance on Rule 144, registration rights may no longer be necessary in many transactions involving OP Units. This would benefit REITs by allowing them to avoid the time and expense associated with such rights, and would be of particular benefit to newly public REITs, which must wait for at least twelve calendar months before filing a shelf registration statement on Form S-3. For REITs that have already provided registration rights to OP Unit

holders, the flexibility provided by the BAML Letter may cause some REITs to discontinue the use of existing registration statements. This may be especially true for well-known seasoned issuers that are required to file a new registration statement every three years.

Block Trades

We expect the BAML Letter to facilitate block trades of REIT common stock because block trades now may be accomplished at the time the OP Unit holder converts the OP Units into REIT common stock, regardless of whether there is an effective resale registration statement on file with the SEC.

Pledges of OP Units

Prior to the BAML Letter, a pledge of OP Units as security for a derivative or other transaction was generally understood to result in a new holding period for the pledgee upon a redemption request by the pledgee after a default by the pledgor. The BAML Letter significantly enhances the value and liquidity of OP Units pledged as security because bona-fide, recourse pledgees may now structure pledges in a manner that would allow the pledgee to receive shares of REIT common stock with a Rule 144 holding period that commenced on the date the OP Units were initially acquired by the pledgor. If the pledgee is able to tack its own holding period to the pledgor's holding period pursuant to the specific tacking provision in Rule 144(d)(3)(iv), the pledgee no longer will need to either (i) hold REIT common stock received upon conversion of OP Units for at least six months prior to any resale under Rule 144, or (ii) obtain the right to require the REIT to register with the SEC the pledgee's resale of the common stock (thereby obviating the need for the REIT to maintain a shelf registration statement registering the resale of REIT common stock, as described above).

Margin Loans

The BAML Letter also provides significant benefits to OP Unit holders seeking margin credit. Before the interpretive guidance, most lenders were unwilling to lend against OP Units because a default by the borrower would have required the lender to request a redemption from the REIT and, often, to wait at least six months before selling the REIT common stock. Lenders may now be comfortable that OP Units that have been held by the OP Unit holder for the full Rule 144 holding period (six months if the issuer is current in its periodic reporting, and one year until no review of the issuer's Exchange Act reporting is required) may be immediately resold by the lender upon default, as long as the lender is itself able to rely on the pledge tacking provision in Rule 144(d)(3)(iv).

Hedging in Connection with Derivative Transactions

Similarly, potential counterparties to derivatives transactions involving OP Units often were unable to effectively hedge such transactions due to the concern that the related hedging sales (e.g., short positions) of REIT common stock could be deemed public sales of such stock by the OP Unit holder accomplished without an effective registration statement or valid exemption from registration. The BAML Letter substantially facilitates short positions in hedging activities related to such derivative transactions by eliminating these Securities Act Section 5 concerns, as long as the OP Unit holder has held the OP Units for a sufficient time period, depending on the structure of the hedging transaction.^[1]

Understanding the scope and specific application of the BAML Letter is therefore an important step when evaluating the formation of UPREITs and similar corporate structures, as well as potential derivative and lending transactions in connection with securities issued in those structures. However, the Securities Act implications for any such transactions are to some extent unique and therefore require a careful examination and complete understanding of the transaction's particular facts and circumstances.

If you have any questions regarding the BAML Letter, any other letters or issues discussed in this alert, or how to structure transactions consistent with relevant precedent, please contact the authors of this alert or your OMM advisor. In addition, the authors of this alert wish to thank Glen A. Rae, Eric P. Hambleton, Robert J. Dilworth, Debra Marvin, and Bess Schachner of Bank of America Merrill Lynch, Hogan Lovells US LLP, and Skadden, Arps, Slate, Meagher & Flom LLP, who assisted with the submission of the interpretive request to the Division and were instrumental in assessing relevant legal issues and current market practice.

[1] Parties to derivatives transactions that involve related hedging sales should consider Section 16(c) short sale implications if any of the parties to the transaction are subject to Section 16 of the Exchange Act, and should note the related interpretive letter from the Commission's Division of Corporation Finance to Credit Suisse addressing Section 16(c) treatment of common stock underlying vested, in-the-money options. See Credit Suisse First Boston, SEC No-Action Letter (March 18, 2004).

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