General Counsels Agenda Meeting

Wednesday, April 1st
9:45am – 11am
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
Shirley Goza, General Counsel, QTS Realty Trust, Inc.

Panelists:
Daniel Adams, Partner, Goodwin Procter LLP
Frank Burt, SVP & General Counsel, Boston Properties, Inc.
Elizabeth Sacksteder, Partner, Paul Weiss

[As reprinted from *REIT Zone Publications*, September 3, 2014]

GETTING NOTHING FOR SOMETHING

James J. Hanks, Jr.[*]

A lot of controversy has recently been swirling around Subtitle 8 of Title 3 of the Maryland General Corporation Law ("Subtitle 8"), especially its provision that allows a board of directors to classify itself into three classes without a stockholder vote and despite any contrary provision in the charter or bylaws. In fact, Subtitle 8 has been the law in Maryland since 1999, when the Maryland legislature, by overwhelming margins, approved the Unsolicited Takeovers Bill, which was signed by the Governor and became effective on June 1, 1999.

Subtitle 8 (occasionally called the "Maryland Unsolicited Takeovers Act" or "MUTA") permits a Maryland corporation (or a Maryland real estate investment trust formed under Title 8) with a class of equity securities registered under the Securities Exchange Act of 1934 and at least three independent directors to elect, by provision in its charter or bylaws or by resolution of its board of directors and notwithstanding any contrary provision in the charter or bylaws, to be subject to any or all of five provisions, including:

- a classified board;
- a two-thirds vote of outstanding shares to remove a director;
- a requirement that the number of directors be fixed only by vote of the board of directors;
- a requirement that a vacancy on the board of directors be filled only by the affirmative vote of a majority of the remaining directors and for the remainder of the full term of the class of directors in which the vacancy occurred and until a successor is elected and qualifies; and
- a provision that a special meeting of stockholders must be called upon stockholder request only on the written request of stockholders entitled to cast a majority of the votes entitled to be cast at the meeting.

Subtitle 8 also permits the charter or a board resolution to prohibit the corporation or a Title 8 real estate investment trust from electing to be subject to any or all provisions of the Subtitle. (For convenience hereafter, we shall refer just to a REIT, whether formed under the Maryland General Corporation Law as a corporation or under Title 8 as a real estate investment trust.)

For many years, newly formed Maryland REITs have adopted classified boards and the substance of the other Subtitle 8 protections in their original charters or bylaws and have

---

[*] Partner, Venable LLP, Baltimore, Senior Lecturer, Northwestern Law School. Author, *Maryland Corporation Law* (Wolters Kluwer, 1990, supplemented annually). Mr. Hanks participated in the drafting of Subtitle 8.

thus not needed to opt in to Subtitle 8. Some pre-1999 REITs and some post-1999 REITs without classified boards or other Subtitle 8 provisions have opted in to Subtitle 8 to adopt one or more of its provisions.

For the past several years, classified boards, like shareholder rights plans and plurality voting, have been under attack by proxy advisers, institutional shareholders and academics. These attacks have asserted the need for more "accountability" and a fear of "entrenchment." In more recent years, some of these same activists have gone even further and demanded that boards not only declassify, redeem their rights plans and give up plurality voting but also promise never (at least without a shareholder vote) to reclassify, adopt a new rights plan or revert to plurality voting. In Maryland, as Barry Vinocur has pointed out, at least 13 REIT boards have declassified (or promised to do so in the near future) and adopted a charter provision that the REIT will not reclassify under Subtitle 8 without a shareholder vote. A shareholder vote, of course, requires an annual or special meeting of shareholders, a process likely to take at least several months, typically not soon enough to provide any timely or effective benefit to a company under attack.

Nevertheless, the pressure for REIT boards to give up the right to classify (or reclassify) under Subtitle 8 continues. Boards are wise to resist this pressure for several reasons:

1. *There is no economic benefit to the REIT.* Declassifying (or promising not to classify or reclassify) will not lease more space, increase rents or lower interest rates. It may pick up some points on Green Street's scorecard but plenty of REITs have successfully sold equity with classified boards. Generally speaking, it is better for a company to have more choices than fewer. For example, I do not know of a single REIT charter that caps a board's power to borrow. So, why give up, for no economic benefit to the REIT, an option that may provide some protection against an effort by investors or activists with goals other than those typically held by long-term shareholders to seize control of the company on a short-term basis in what may be temporarily unfavorable market conditions? The decision to opt out of Subtitle 8 is not whether to classify the board, which would at least be discussable in terms of good or bad corporate governance (see next paragraph), but whether to effectively give up *even the choice* of classifying the board at some future time under unknown circumstances, thereby tying the hands of all future boards.

2. *There is no significant reliable data showing a correlation, much less causation, between non-classified boards and economic performance.* Economic performance of REITs is driven by management and assets, not by corporate governance. Just last year, using a comprehensive sample for the period from 1978 through 2011, Martijn Cremers, Lubomir P. Litov and Simone M. Sepe, in *Staggered Boards and Firm Value, Revisited*, showed that firms adopting a classified board increase in firm value and, conversely, that declassifying is associated with a decrease in firm value. Likewise, in 2010, Michael E. Murphy, in *Attacking the Classified Board of Directors: Shaky Foundations for Shareholder Zeal*, concluded that the value of companies with and without classified boards was nearly identical and that the effects on company value were insignificant if the company's shares are widely held, without a ten percent or greater shareholder.

Indeed, Murphy surveyed previous literature (including articles by Harvard Law Professor Lucian Bebchuk, a well-known vocal opponent of classified boards) to conclude that classified boards do not affect operational performance and noted that there is some evidence to support the conclusion that companies with classified boards have improved operational performance. In short, Murphy concluded that classified boards actually have a very wide range of impacts on companies, and thus a "case-by-case" approach is best. There are other studies reaching similar conclusions.

3. *The primary purpose of classified boards is to provide continuity and stability to the company and its management in developing and executing its strategies.* Classified boards have been around for nearly 100 years. They encourage the recruitment and retention of new directors by permitting them a reasonable period of time to become familiar with the company before coming up again for election. Developing, implementing and executing a long-term strategy can generally not be done in only one year. REIT boards and managements found this out during the financial crisis when they were forced to refinance their companies and reposition their assets, often resulting in major strategic changes, the benefits of which may not be realized in only one year. The courts for years have held that the power to set the time horizon over which the company will be operated rests squarely with the board. As a necessary corollary, the board is entitled to protect the company from changes to its strategies and policies. This is especially true where the board makes a choice explicitly conferred on it by the legislature.

4. *The board, as the elected representatives of the shareholders and with more information than any single shareholder, is in the best position to decide on appropriate protections for its strategies.* Not content with electing the board and letting it choose and evaluate the CEO and collaboratively develop the company's strategy, some shareholders and uninvested activists want to tell the board what to do. We see this encroachment especially in the recommendations of Institutional Shareholder Services Inc. ("ISS") to withhold or vote against directors for a single small infraction of ISS's policies, *regardless of the company's economic performance*. ISS also threatens to, and often does, recommend against directors who fail to implement within the following year even just one precatory proposal approved by shareholders, regardless of the company's economic performance – a position diametrically opposite to generations of settled corporate law in Maryland, Delaware and elsewhere. Even more vividly, we see this encroachment in the efforts to restrict the board's exercise of its rights under Subtitle 8 to protect its strategies and policies. These moves are often advanced as a supposed antidote to "entrenchment" or as promoting "accountability." Entrenchment, of course, is a loaded label and accountability sounds good but the result of depriving the board of the opportunity for limited protection of its business plan is exposure to attacks by holders with very different economic (or other) goals than shareholders generally. Take, for example, arbitrageurs, hedgers and "underweight" holders who openly pursue investment strategies very different from the value maximization sought by most shareholders. Indeed, one labor organization whose primary interest is organizing employees, not shareholder value, Unite Here, typically a small holder in its target companies, has

successfully proposed opting out of the Subtitle 8 classified board provision at several lodging REITs.

5. *A classified board will not prevent a takeover*. It is now common for a bidder in a hostile tender offer to reinforce its tender offer with an announcement of intention to file a competing slate of director nominees at the next annual meeting of shareholders. A classified board will give the incumbent directors additional time to consider the bidder's proposal, explore alternatives and, often, negotiate with the bidder. Because the board has the power to declassify (if it has classified itself under Subtitle 8) or to initiate declassification (if the board is already classified in the charter) and to remove other defensive measures, it has leverage in negotiating with an otherwise hostile bidder, who will almost always prefer paying more for a sure deal today than running proxy contests of uncertain outcome at two annual shareholders meetings.

In summary, it is difficult to see how a board maximizes value for the shareholders – the ultimate goal of any for-profit enterprise – by tying the hands of future boards by surrendering, effectively forever, a valid choice, like the power to classify, specifically conferred by statute, in return for no economic benefit for the REIT. Directors should be especially careful that they do not fall into the trap, of which they are so often unjustly accused, of appearing to act in their own self-interest by yielding to pressure, especially from unelected activists with little or no skin in the game, to opt out of Subtitle 8, in order to avoid a recommendation by ISS or Glass Lewis & Co. to withhold or vote against directors in a subsequent election.

2014-2015 YEAR-END TOOL KIT

DODD-FRANK COMPENSATION DISCLOSURE AND CONFLICT MINERALS UPDATE

December 2014

Update on Pending Compensation Rulemaking Under the Dodd-Frank Act

Speed read: The status of the four compensation-related SEC rulemaking mandates remains unclear. The SEC has proposed (but not adopted) rules for pay ratio disclosure, and has yet to propose rules for CEO pay for performance, clawbacks and hedging. In late November 2014, an informal, non-binding regulatory agenda published by the SEC indicated that the SEC had established October 2015 as the target date for adoption of final CEO pay ratio disclosure rules and proposal of the pay for performance, clawbacks and hedging disclosure rules. These rules are the subject of ongoing political controversy, and it is possible that the new Congress will act to amend or repeal the sections of the Dodd-Frank Act that required the SEC to adopt these rules. Companies should continue to monitor the status of these rules.

The Dodd-Frank Wall Street Reform and Consumer Protection Act required the SEC to adopt rules relating to CEO pay ratio disclosure, stock exchange listing standards requiring clawbacks of incentive compensation in certain circumstances, hedging policy disclosure and pay for performance disclosure. As of mid-December 2014, the SEC had taken no action since September 2013 on these rulemaking mandates. The CEO pay ratio disclosure rules remain in the form proposed by the SEC in September 2013, and the SEC had not yet proposed rules for clawbacks of incentive compensation under stock exchange rules, hedging policy disclosure or pay for performance disclosure.

Proposed CEO Pay Ratio Disclosure Rules. The SEC proposed CEO pay ratio disclosure rules pursuant to a Dodd-Frank mandate on September 18, 2013. As proposed, the CEO pay ratio rules provided a transition period under which disclosure would not have been required for calendar year 2014 compensation (to be disclosed in 2015 proxy statements). As noted above, an internal SEC agenda indicates that the SEC may not adopt final rules until October 2015. Based on the phase-in provided in the original proposal, it is possible that if the SEC adopts final CEO pay ratio rules in late 2015, CEO pay ratio disclosure would not be required for calendar-year companies until 2016 (for disclosure in 2017 proxy statements).

Under the CEO pay ratio proposal, public companies would have to disclose the median of annual total compensation for all employees of the company other than the chief executive officer for the last completed fiscal year; the annual total compensation of the chief executive officer for the last completed fiscal year; and the ratio of these two amounts. The disclosure of the pay ratio may be presented as a fraction (*e.g.*, “1 to [the appropriate multiple]”), or in narrative form (*e.g.*, “the CEO’s annual total compensation is X times that of the median of the total annual compensation of all employees”). The proposed rules contained exemptions for smaller reporting companies, emerging growth companies and foreign private issuers.

The proposed CEO pay ratio disclosure would cover all employees of the company and any subsidiary of the company (defined as an affiliate controlled by the company directly or indirectly through one or more intermediaries), including all full-time, part-time, temporary, seasonal and non-U.S. employees who were employed as of the last day of the company's prior fiscal year. Workers who are not employed by the company or its subsidiaries, including independent contractors, "leased" employees or other temporary workers employed by a third party, would be omitted.

Under the proposed rules, companies could annualize the total compensation of permanent employees who were employed for less than the full fiscal year. Companies could not, however, make full-time equivalent adjustments for part-time employees, annualize compensation for temporary or seasonal workers, or make cost-of-living adjustments for non-U.S. employees.

The proposed rules would allow companies to select a reasonable method to identify the median employee and to use reasonable estimates to determine any element of total compensation for the median employee and the annual total compensation for the median employee. The proposed rules would require companies to disclose briefly the methodology used to identify the median employee, including the compensation measure used and any material assumptions, adjustments or estimates. The narrative disclosure is intended to be a brief overview, and disclosure of technical analyses or formulas is not required. If a company estimates total annual compensation, the resulting disclosure would need to be clearly identified as an estimated amount and include a brief description of the estimates used by the company. If a company changes its methodology from a prior period and the effects of such change are material, the company must briefly describe the change, the reasons for the change and the expected impact on the median and the ratio.

For additional information about the SEC's proposed pay ratio rules, see our Client Alert "SEC Issues Proposed "Pay Ratio" Disclosure Rules" (October 2, 2013).

Clawbacks. The Dodd-Frank Act requires the SEC to adopt rules directing stock exchanges to prohibit the listing of securities if the company has not developed and implemented a policy for the recovery of incentive-based compensation in certain circumstances. Unlike the comparable clawback requirements of the Sarbanes-Oxley Act clawback provision, the Dodd-Frank Act clawback policy must cover both current and former executive officers, rather than just the chief executive officer and the chief financial officer, and applies to any accounting restatement resulting from material non-compliance, without regard to whether the executive officer is responsible for misconduct that led to the restatement. Companies would be required to disclose their clawback policies.

Some companies have adopted clawback policies in advance of the final rules, in some cases because adoption and disclosure of a clawback policy may affect corporate governance ratings by proxy advisory firms. Because the SEC's current internal agenda indicates that the Dodd-Frank clawback rules may not be proposed until October 2015, and implementation of these rules will require rulemaking proposals and adoption by the SEC and then by the stock exchanges, the Dodd-Frank clawback rules are not likely to affect companies until at least the 2016 proxy season.

Hedging. The Dodd-Frank Act also requires the SEC to adopt rules requiring companies to disclose whether employees and directors are permitted, directly or indirectly, to hedge the market value of compensatory securities grants and awards. This disclosure is in addition to existing SEC requirements that companies disclose any policies regarding hedging the economic risk of owning company securities by the company's named executive officers in proxy statements.   Like the clawback rules, the SEC's internal agenda for its rulemaking proposal indicates that it is unlikely that the hedging policy disclosure requirements will apply until at least the 2016 proxy season.

Pay for Performance. The third compensation-related Dodd-Frank Act rulemaking mandate that remains unproposed at this time is the requirement that the SEC to adopt pay for performance disclosure rules. These rules would require companies to disclose material information showing the relationship between executive compensation actually paid and the financial performance of the company, taking into account any change in the value of the company's stock and the dividends paid by the company. Like the clawback and hedging rules, the SEC's internal agenda for its rulemaking proposal indicates that it is unlikely that the hedging policy disclosure requirements will apply until at least the 2016 proxy season. Companies should monitor SEC rulemaking in this area, however, because the proposed rules may provide insights concerning final SEC rules that compensation committees may wish to consider when they adopt compensation programs and make compensation decisions.

Update on Conflict Minerals

Speed read: The final status of the SEC's conflict minerals rules remains uncertain. There has been no substantive change from the legal position when 2013 reports were filed in late May and early June 2014. Litigation still pending before the D.C. Court of Appeals could strike the current limited order that prevents public companies from being required to state whether their products are "DRC conflict free." That would ultimately result in companies becoming obligated to comply with the conflict minerals rules as originally adopted by the SEC, after all appeals had been dealt with. Meanwhile, it is also possible that legislation that would amend the Dodd-Frank Act to eliminate the conflict minerals rule could be adopted by the House of Representatives and the Senate in 2015. Until these uncertainties are resolved, companies should continue to monitor developments, and should be prepared to file reports in 2015 on the same basis that they did in 2014.

Section 1502 of the Dodd-Frank Act required the SEC to adopt rules requiring public companies to disclose their use of coltan, cassiterite, gold and wolframite if those minerals (i) originated in the Democratic Republic of the Congo (the "DRC") or an adjoining country and (ii) are necessary to the functionality or production of their products. As a required by the Dodd-Frank Act, the SEC adopted Rule 13p-1 in August 2012, which requires companies to prepare and file annually a Form SD and, in some circumstances, a Conflict Minerals Report.

After the U.S. District Court for the District of Columbia ruled against a challenge to the SEC's conflict minerals rule, the U.S. Court of Appeals for the D.C. Circuit issued an opinion in April 2014 upholding the lower court's decision in all respects other than on First Amendment grounds. The Court of Appeals held that the relevant section of the Dodd-Frank Act and the SEC's conflict minerals rule violated the First Amendment by unconstitutionally compelling speech to the extent they require issuers to report to the SEC and state on their website that any of their products have "not been found to be 'DRC conflict free.'"

To deal with the resulting uncertainties about how companies should comply with the conflict minerals rule in light of the litigation, the SEC Division of Corporation Finance issued a statement in April 2014 indicating that companies were required to comply with the conflict minerals rule and to file a Form SD by the June 2, 2014 deadline, but were not required to describe their products as being "DRC conflict free," having "not been found to be 'DRC conflict free,'" or "DRC conflict undeterminable." Pending further action, companies would also not be required to obtain an independent private sector audit unless they voluntarily described their products as "DRC conflict free." The April 2014 SEC statement can be found here.

Following up on the April SEC statement, the SEC issued an order in May 2014 staying the effective date for compliance with the portions of the conflict minerals rule and Form SD that had been found invalid by the courts. The SEC's May 2014 press release discussing the order can be found here, and the order itself can be found here.

As of mid-December 2014, the conflict minerals litigation remains unresolved. On August 1, 2014, the full U.S. Court of Appeals for the District of Columbia Circuit issued an opinion in the appeal of *American Meat Institute v. US Department of Agriculture* that upheld a Department of Agriculture "country-of-origin" labeling requirement that had been challenged on First Amendment grounds that were similar to the grounds on which the SEC conflicts minerals rules had been declared in part unconstitutional. On November 18, 2014, the three-judge panel of the D.C. Circuit Court of Appeals that had issued the decision finding the SEC conflict minerals rule invalid in part on First Amendment grounds issued an order requiring the parties to submit briefs relating to the impact of the *American Meat Institute* decision on its earlier conflict minerals ruling and deferring action on pending motions for *en banc* rehearing of an appeal in the conflict minerals rule litigation.

It is possible that the conflict minerals provisions of the Dodd-Frank Act will be among those that the new Congress will consider amending in 2015. For these reasons, companies required to file Form SD should monitor developments in the coming months to determine if any disclosure changes are needed and whether the Congress modifies or eliminates the conflict minerals mandate.

Corporate Governance

June 23, 2014
DJIA: **16,937** | RMZ: **1030** | 10-Yr Treasury Note: **2.62%**

Green Street Advisors

Ranking the Public Real Estate Companies

Overview: The wide range of corporate governance practices within the REIT industry can meaningfully impact share prices. A systematic approach to evaluating the spectrum of practices is essential to gain perspective. The updated governance rankings contained herein provide the necessary framework.

Corporate Governance Highlights:

- Overall, the REIT industry stacks up in line with corporate America on governance
- There is more to good governance than "checking-the-boxes"; a full one-quarter of the Green Street ranking system is based on board conduct
- **Prologis, Host, DCT Industrial Trust,** and **DiamondRock** all recently took steps to ensure that MUTA, a particularly objectionable entrenchment device available to the 70% of REITs that are incorporated in Maryland, will never be used against shareholders. The other Maryland REITs should follow their lead.
- **LaSalle Hotel Properties** and **Mack-Cali Realty** became the latest REITs to do away with the classified board structure. The 10% of REITs that have retained this outdated structure increasingly stick out like sore thumbs.

Peter Rothemund, CFA

660 Newport Center Drive, Suite 800, Newport Beach, CA 92660
T 949.640.8780 F 949.640.1773

Important disclosure on pages 21-22

This excerpt is from Green Street Advisors' Executive Compensation and Corporate Governance Report, June 23, 2014.

Corporate Governance
Overview

Corporate Governance
A Review of Governance Practices in the Public Real Estate Sector

Companies with good governance should and do trade at valuation premiums relative to companies with poor governance. Because of this, Green Street regularly and systematically assesses governance for each of the companies in our coverage universe. Our rankings take into account subjective factors specific to individual companies as well as objective factors unique to the REIT industry, both of which serve to differentiate these rankings from those published by governance ranking specialists (e.g., ISS). These governance scores constitute a key input in our primary REIT valuation model.

Assessing corporate governance is no easy task because it is comprised of so many different variables. Governance is a composite of structural features embedded in corporate charters and bylaws, the make-up and structure of the board of directors, and the attitudes and behavior of management and the board. The goal of providing a comprehensive overview needs to be balanced with the competing goal of keeping an eye on the big picture.

Our governance rankings are predicated on two key observations:

1. Companies have a litany of anti-takeover devices from which they can choose. The choices a company makes on this front send a strong signal about the board's attitude toward governance. It is fair to assume that boards that avail themselves of more potential anti-takeover devices are more likely to use them in a manner adverse to the interests of outside shareholders.

2. The center of governance in any corporation is its board of directors. Boards that make themselves accountable to shareholders via annual elections are much more likely to behave in a shareholder-friendly manner. Also, boards comprised of members who have no conflicts and/or have serious "skin in the game" are desirable.

Recent changes to the ranking system: Last September two changes were made to the governance scoring system: 1) greater emphasis was placed on board behavior (25 pts out of the maximum possible of 100 are now reserved for board conduct) and 2) governance scores for companies where insiders control enough votes to act as deterrents to activists/suitors were lowered. See Heard on the Beach – Let the Mob Rule, Sept 3 2013 for more detail.

Corporate Governance

The Ranking System

Green Street's Governance Scoring System: Our governance ranking system differs in two key respects from those provided by other evaluators: 1) our familiarity with the companies allows for subjective input; and 2) issues unique to REITs (e.g., quirks in Maryland corporate law, the 5 or fewer rule) are ignored by others. Scoring is on a 100-point basis with the key inputs highlighted below. A more thorough description of the variables can be found in Appendix D.

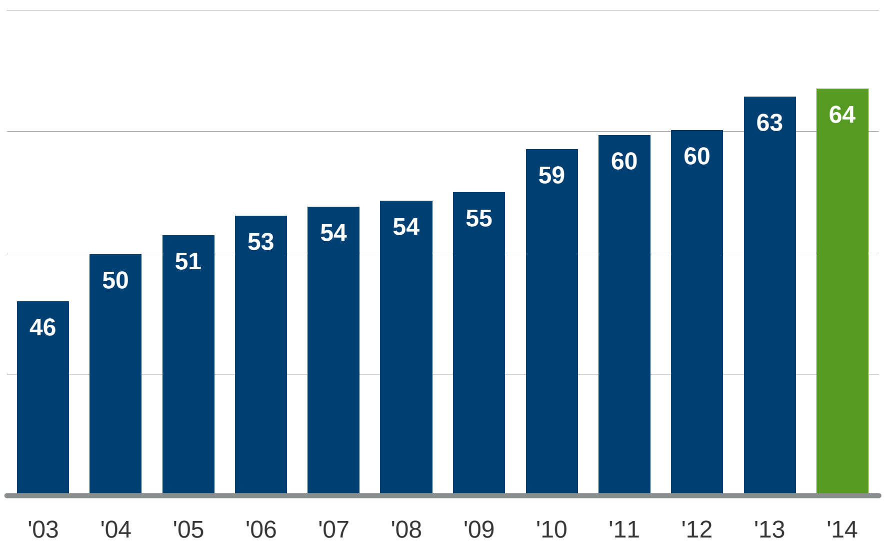
Category	Max Points	Ideal Structure
Board Rating:		
Non-staggered Board	20	Yes
Independent Board	5	80+%
Investment by Board Members	5	Large Investment by Numerous Members
Conduct	25	No Blemishes, Fair Comp, Leadership
Total	**55**	
Anti-Takeover Weapons:		
State Anti-takeover Provisions	12	Opt out/Shareholders Approve Change
Ownership Limits from 5/50 Rule	5	Limit Waived for Ownership by other REITs
Shareholder Rights Plan	10	Shareholders Must Approve Implementation
Insider Blocking Power	8	No Blocking Power
Total	**35**	
Potential Conflicts of Interest:		
Business Dealings with Management	6	No Business Dealings
Divergent Tax Basis of Insiders	4	Basis Near Share Price
Total	**10**	
Perfect Score	**100**	

Insider blocking power: There are only a handful of REITs where insiders hold a blocking position, but it's a big deal where it exists. Because of that, a cap is placed on how many points a REIT where blocking power is present can score on the anti-takeover variables. For example, a REIT that scores a zero on the blocking power variable (because insiders own enough shares to effectively control any vote) will have any points credited for shareholder-friendly takeover elections the company has made cut in half.

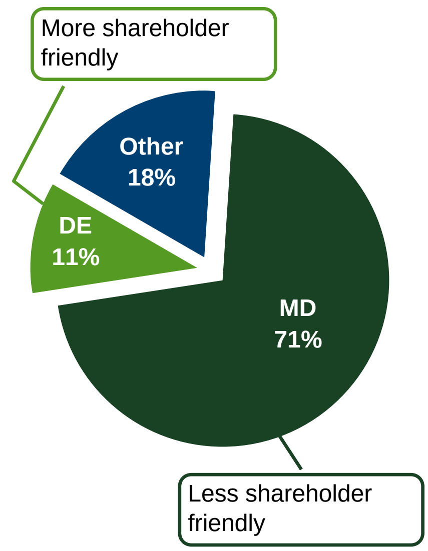
Corporate Governance
Notable Developments

Progress: The push over the past decade to clean up governance structures has led to a dismantling of takeover defenses across REITland and Corporate America alike. Only 10% of REITs retain the outdated classified board structure and a little less than that currently have a poison pill in place – impressive numbers that are comparable to the percentages for S&P 500 companies.

Average Corporate Governance Score



State of Incorporation



Getting Smarter on State Law

Boards have several anti-takeover devices at their disposal and a powerful one available to REITs incorporated in Maryland featured prominently in a takeover battle last year. **The Maryland Unsolicited Takeover Act (MUTA) permits a Maryland corporation to add various anti-takeover provisions, chief among them the ability to stagger the board, to its charter without shareholder approval.** Having a destaggered board, while at the same time retaining the ability to classify it (probably at just the time it matters most), is insulting to investors. REITs incorporated in Maryland should follow the lead of long-time corporate governance leader **Prologis** and the six other REITs that have taken steps to ensure that boards will never be reclassified, by leaving that power in the hands and votes of shareholders.

Highlights

MUTA — **DCT Industrial Trust, DiamondRock Hospitality, Host Hotels & Resorts,** and **Prologis** all recently added language to their corporate charters that prohibits staggering the board without first obtaining shareholder approval.

Destaggering — **LaSalle Hotel Properties** and **Mack-Cali Realty** became the latest REITs to do away with the classified board structure.

Conduct — Board members at **BRE Properties** responded to investor frustation and ultimately "did the right thing." Will the trustees at **Associated Estates** do the same or will investors' voices go unheard?

This excerpt is from Green Street Advisors' Executive Compensation and Corporate Governance Report, June 23, 2014.

Corporate Governance
The Rankings

Wide Disparity: Some REITs have excellent governance structures; others have structures that give insiders enormous powers to ignore the wishes of shareholders. Clients with access to our "Data Tools" product can access detailed company-level scoring on our web site. Perfect score = 100.

Company	Score	Change	Company (cont'd)	Score	Change
Prologis	98	+6	HCP, Inc.	68	+1
Health Care REIT	87		Kimco Realty	68	-1
Ventas	86		MAA	68	
Sunstone Hotel Inv	83	+4	Regency Centers	68	+1
DDR Corp	82	+1	Spirit Realty Capital Inc.	68	-7
DCT Industrial Trust	81	+8	Westfield Group	68	-7
DiamondRock Hospitality	81	+17	Healthcare Trust of America	67	+1
American Tower Corp	79	-6	Liberty Property Trust	67	+3
Brixmor Property Group	79	+1	Macerich	67	-1
American Campus	77		Strategic Hotels	67	+4
Equity Residential	77	+5	Corporate Office Properties	64	-2
Highwoods Properties	77	+1	Public Storage	63	+5
Retail Opportunity Investments Corp	77	-1	UDR, Inc.	63	
Boston Properties	76		Omega Healthcare Investors	62	+1
Federal Realty	76		Alexandria Real Estate Equities	61	+3
Digital Realty Trust	75		LaSalle Hotel Properties	61	+12
Acadia Realty Trust	74		CBL & Associates	60	-1
EastGroup Properties	74		BioMed Realty Trust	59	-2
Host Hotels & Resorts	74	+5	Sun Communities	58	+3
Post Properties	74	-2	AVIV REIT, Inc.	57	
Extra Space	73		Brandywine Realty Trust	56	
First Industrial Realty	73		Washington Prime	56	
Camden Prop Trust	72		Campus Crest Communities	55	-7
Essex Property Trust	72		CoreSite Realty Corp	55	+2
Home Properties	72		AIMCO	53	
Retail Properties of America	72	+2	PS Business Parks	52	
Tanger Factory	72		Pennsylvania REIT	51	+1
Realty Income Corp	71		Equity One	47	-2
Weingarten Realty	71		Mack-Cali Realty Corp	46	+20
AvalonBay	70		General Growth	44	
Douglas Emmett	70	+1	American Assets Trust	42	
National Retail Properties, Inc.	70		Rouse Properties, Inc.	42	
Pebblebrook Hotel Trust	70	-9	Associated Estates	39	+4
Piedmont Office Realty Trust	70		Dupont Fabros Tech	38	
Simon Property Group	70		Washington REIT	37	
Duke Realty Corp	69	-2	Felcor Lodging Trust	34	-2
Kilroy Realty Corp	69		SL Green Realty	34	-1
RLJ Lodging Trust	69	-4	Empire State Realty	33	+1
Cousins Properties	68		Glimcher Realty Trust	33	-3
CubeSmart	68	+5	Healthcare Realty Trust	28	
EdR	68	+5	Vornado Realty Trust	25	
Equity Lifestyle Props	68		Taubman Centers	18	+1
			Average Score	**64**	**+1**

Appendix D
Corporate Governance Ranking System – The Variables

I. Introduction
Companies with good governance should and do trade at valuation premiums relative to companies with poor governance. Because of this, Green Street regularly and systematically assesses governance for each of the companies in our coverage universe. Our rankings take into account subjective factors specific to individual companies as well as objective factors unique to the REIT industry, both of which serve to differentiate these rankings from those published by governance ranking specialists (e.g., ISS). These governance scores constitute a key input in our primary REIT valuation model.

Assessing corporate governance is no easy task because it is comprised of so many different variables. Governance is a composite of structural features embedded in corporate charters and bylaws, the make-up and structure of the board of directors, and the attitudes and behavior of management and the board. The goal of providing a comprehensive overview needs to be balanced with the competing goal of keeping an eye on the big picture.

Our governance rankings are predicated on two key observations:

1. Companies have a litany of anti-takeover devices from which they can choose. The choices a company makes on this front send a strong signal about the board's attitude toward governance. It is fair to assume that boards that avail themselves of more potential anti-takeover devices are more likely to use them in a manner adverse to the interests of outside shareholders.
2. The center of governance in any corporation is its board of directors. Boards that make themselves accountable to shareholders (via annual elections) are much more likely to behave in a shareholder friendly manner. Also, boards comprised of members who have no conflicts and/or have serious "skin in the game" are desirable.

II. About the Ratings
Our evaluation of corporate governance is separated into three key categories. The first of these is an evaluation of the make-up of each board, and, importantly, whether the board is accountable to shareholders. The second broad category measures the power that the board has to make governance decisions vs. the power vested in shareholders. The final category measures potential conflicts of interest between key insiders and shareholders. Our ratings are structured such that the "perfect REIT" would garner a score of 100, with the variables weighted according to the importance we believe they deserve.

A. Rating the Board
No aspect of corporate governance is more important than the composition of a company's board. Boards control enormous power. In the specific case of change of control issues, boards generally control the “trigger” with regard to some extremely potent weapons. In addition to these change of control issues, boards are responsible for ensuring that corporations behave in a manner consistent with the best interests of shareholders on all other fronts. Because the board's roles are so varied and important, any analysis of corporate governance has to place substantial weight on both the structure and membership of the board. 55 of the 100 points available in our rating system pertain to the quality and structure of the board.

As defined herein, the "perfect board" would have the four characteristics described below. Not surprisingly, these same characteristics constitute the variables we use to rate board strength.

1. **Boards should have an annual, not staggered, election of all directors.** Investors feel much more comfortable giving boards considerable power if they have a way of reigning in or firing boards that abuse those powers. **Accountability is so important that this is one of the most important variables (20 of 100 points) in our rating system.**
2. **A high percentage of directors should be independent.** The New York Stock Exchange has guidelines that afford considerable leeway for companies to define what constitutes an "independent" director. The idea that boards are left with discretion to make this determination strikes us as inappropriate, and our categorization of independent directors leaves much less room for business relationships between the director, or his employer, and the company.

3. **Multiple board members, including both insiders and independents, should hold sizable investments in the company.** Most board members today have impressive looking resumes, but when they don't "eat their own cooking", they tend not to utilize the skills that made them successful in the first place. Companies can promote this goal by paying board fees in stock, requiring members to hang on to that stock, and imposing share ownership minimums on board members.

4. **Reputation matters.** While this variable is obviously subjective, it is also very important. Some boards have been stress tested on change-of-control questions, many have dealt with issues where shareholder interests and managerial interests diverge, and all have dealt with executive pay questions. Our annual review of Executive Pay can have a big influence on this variable.

B. Evaluating the Anti-Takeover Tools

The primary entrenchment tools available to all companies are state antitakeover laws and poison pills. Anti-takeover devices that are more unique to the REIT sector include ownership limitations arising from the "5 or fewer" rule and the ability of founders/insiders to veto major transactions. It is impossible to determine ahead of time whether boards that have availed themselves of these tools would use them inappropriately, and it is also unwise to assume that a board that does not have certain of these features in place today might not put them in place when push comes to shove. Nevertheless, insight regarding the mindset of a board can be gleaned by reviewing which of these objectionable devices are in place.

1. **State Antitakeover Laws** - Well over half of the REITs in our coverage universe are incorporated in Maryland, a state whose corporate law (known by the acronym "MGCL") can be used to thwart the possibility of hostile takeovers. A number of other states have similar laws. MGCL establishes provisions that protect shareholders from "business combinations" involving "interested stockholders" as well as unsolicited takeover attempts. The key sections of this law serve as enormous impediments for hostile takeovers. A Maryland company may choose to opt out of these provisions, although boards generally hold the power to change prior elections any time in the future.

   - **Section 3-602: Otherwise referred to as the "Business Combination" provision.** The law prohibits for a period of five years a merger (or similar transaction) between a company and an "interested stockholder". An interested stockholder is defined as someone owning 10% or more of the voting stock. A business combination that is approved by the Board before a person becomes an interested stockholder is not subject to the five-year moratorium or special voting requirements. After five years, three things are required:
     1. Approval of the transaction by the Board of Directors.
     2. Approval by >80% of all shares outstanding.
     3. Approval by >2/3 of all shares excluding those owned by the interested stockholder.

   - **Section 3-701 through 3-710: Otherwise referred to as the "Control Share Acquisition" provision.** Defines a "Control Share Acquisition" as having occurred when a shareholder passes any of three ownership thresholds (20%, 33.3% and 50%). Once an individual or group passes one of these thresholds, voting power is stripped from their shares unless such voting power is reaffirmed by a 2/3 vote of shares not held by the acquiring person.

   - **Section 3-801 through Section 3-805: Otherwise referred to as "The Maryland Unsolicited Takeover Act (MUTA)":** Among other things, the law permits, without shareholder approval, the board of Maryland corporation to:
     1. Elect a classified board
     2. Enact a majority requirement for calling a special meeting of stockholders
     3. Require a two-thirds vote to remove directors
     4. Restrict the number and replacement of existing directors

   A REIT that has not opted out of these clauses would appear to be "takeover proof" absent the blessing of the Board. Explicit bylaw safeguards are necessary to ensure that these onerous laws can never be used to fend off a suitor absent the approval of shareholders. Companies incorporated in Maryland or similar states are accorded credit in our system if they have opted out of these laws. They are accorded more credit if they have bylaws preventing them from ever opting in. Companies located in states that don't have laws of this sort do not have these anti-takeover devices available, so they receive a good score in our rating system.

2. **Poison Pills or Shareholder Rights Plans -** Although their terms and conditions vary considerably, the stated purpose of a poison pill is to force potential bidders to negotiate with a target company's board of directors. If the board approves the deal, it may redeem the pill. If the board does not approve a bid and the potential acquirer proceeds anyway, the pill would be triggered. The "poison" in the pill is generally the issuance of a new class of preferred stock that is massively dilutive to the ownership and voting power of the suitor. Poison pills typically do not have to be ratified by shareholders, and even those companies that do not currently have a poison pill can put one in place subsequent to receiving a hostile bid. Our scoring gives credit for not having a pill in place (most REITs fit this category), and additional credit is given to companies that have explicitly transferred authority regarding poison pills to shareholders, instead of their boards (though rare, a small number of REITs have done this).

3. **Ownership Limits Arising from the "5 or Fewer" Rule -** One of the requirements in the tax code for a company electing REIT status is that not more than 50% of the outstanding shares of a REIT may be owned by five or fewer individuals ("individuals" may include certain entities). As a result, the vast majority of REITs have a rule restricting ownership of any individuals or entities to eliminate any chance that this rule may be violated. In most instances, the ownership limit is just below 10%, although for some companies where insiders (who are typically exempted from this rule) control a large amount of stock, the limit is more restrictive. More than any other attribute unique to REITs, the presence of these restrictions makes REITs harder to take over than is the case for other corporations.

   While the presence of these ownership limits is entirely legitimate, their use as an anti-takeover device has nothing to do with their original intent. Most potential hostile acquirers would present no threat of violating the "5 or fewer" rule. By way of example, if the acquirer is a REIT, the tax code allows a "look through" of the REIT entity to the numerous shareholders of that REIT. Because of this, the acquisition of a sizable share block by another REIT presents no cause for concern that the target's tax status would be compromised, but a Board could still use the ownership limit as a deterrent to a hostile takeover.

   The vast majority of REITs have ownership limitations in place, and most have written these limitations in a manner where they could be used by the board to deter a suitor. Since REITs have the entire arsenal of normal corporate anti-takeover devices at their disposal, it is objectionable that so many have made this added entrenchment device available as well. Credit is given in our scoring system to companies that have explicitly attempted to neutralize the anti-takeover aspects associated with their ownership limitations.

4. **Insider Blocking Power -** Companies where insiders control a large stake can, for all practical purposes, only be taken over if management agrees. And in many instances, management will never agree. Our scoring system penalizes companies where insider blocking power is present. Further, because this power trumps everything else, companies where insiders control the vote should not receive full credit on the other anti-takeover variables even if they've made the right choices. Companies with complete veto power will receive only half credit on the other anti-takeover variables, and companies with partial blocking power (i.e., 15-35% insider votes) will receive something between half and full. An exception is made in those cases where the interests of the controlling shareholder are aligned with those of outside shareholders; these companies are typically awarded full credit for their anti-takeover elections even though they score less than perfect on the insider blocking variable.

C. Potential Conflicts of Interest

Potential conflicts arising from divergent interests of key insiders and shareholders represent the final category of variables that comprise our governance ratings.

1. **Business Relationships with Management/Board Members -** REITs have come a long way from earlier structures in which they were generally externally advised, i.e., they contracted with insider-owned entities for most management services. Indeed, business dealings between insiders and their companies are either non-existent or immaterial at the large majority of the companies in our coverage universe.

2. **Extent to which Insiders' Basis Differs from Outside Shareholders' Basis -** A CEO who has been at the helm of a successful company for a long time generally has a tax basis in his shares that is much lower

than the basis of an investor who has built a position in recent years. Divergent tax bases can create a large difference in the way two parties perceive major transactions, such as a cash sale of the company. Because of this, interests of insiders and shareholders are generally better aligned where tax bases are more closely aligned. Because it is very difficult to obtain tax basis information for insiders, our ratings on this variable represent our best estimate based on how long insider shares have likely been owned and how much appreciation (and real estate depreciation) has taken place over that time. It is somewhat ironic that certain underperforming REITs score high on this variable solely because their stock prices have been stagnant, but in terms of rating governance, this is appropriate. It does, however, highlight the need to consider factors other than governance in selecting stocks.

Green Street's Disclosure Information

Analyst Certification – The research analysts listed below hereby certify that all of the views expressed in this research report accurately reflect their personal views about any and all of the subject companies or securities. They also certify that no part of their compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report. Research Analysts: Peter Rothemund.

Issuers of this Report US and EEA This report has been prepared by analysts working for Green Street Advisors (GSA (US)) and/or Green Street Advisors (U K.) Limited (GSA (UK)), both of which are subsidiaries of Green Street Holdings, Inc.

This report is issued in the USA by GSA (US). GSA (UK) accepts no responsibility for this report to the extent that it is relied upon by persons based in the USA. GSA (US) is regulated by FINRA and the United States Securities and Exchange Commission, and its headquarters is located at 660 Newport Center Drive, Suite 800, Newport Beach, CA 92660.

This report is issued in the European Economic Area (EEA) by GSA (UK). GSA (US) accepts no responsibility for this report to the extent that it is relied upon by persons based in the EEA. GSA (UK) is registered in England, (Company number. 6471304), and its registered office is 22 Grosvenor Square, 3rd Floor, London, W1K 6LF. GSA (UK) is authorized and regulated by the Financial Conduct Authority in the United Kingdom and is entered on the FCA's register (no. 482269]).

References to "Green Street" in Disclosures in this section and in the Other Important Information section apply to
- **GSA (US) to the extent that this report has been disseminated in the USA or**
- **GSA (UK) to the extent that this report has been disseminated in the EEA.**

Green Street Advisors US is exempt from the requirement to hold an Australian financial services license under the Act in respect of the financial services; and is regulated by the SEC under US laws, which differ from Australian laws.

Green Street Advisors UK Ltd. is exempt from the requirement to hold an Australian financial services license under the Act in respect of the financial services; and is regulated by the FCA under UK laws, which differ from Australian laws.

Green Street reserves the right to update the disclosures and policies set out in this document at any time. We encourage a careful comparison of these disclosures and policies with those of other research providers, and welcome the opportunity to discuss them.

For Green Street's advisory customers, this research report is for informational purposes only and the firm is not responsible for implementation. Nor can the firm be liable for suitability obligations.

Affiliate Disclosures Green Street does not directly engage in investment banking, underwriting or advisory work with any of the companies in our coverage universe. However, the following are potential conflicts regarding our affiliates that should be considered:
- Green Street is affiliated with, and at times assists, Eastdil Secured, a real estate brokerage and investment bank, when Eastdil Secured provides investment banking services to companies in Green Street's coverage universe. Green Street is never part of the underwriting syndicate, selling group or marketing effort but Green Street may receive compensation from Eastdil Secured for consulting services that Green Street provides to Eastdil Secured related to Eastdil Secured's investment banking services. Green Street does not control, have ownership in, or make any business or investment decisions for, Eastdil Secured.
- Green Street has an advisory practice servicing investors seeking to acquire interests in publicly-traded companies. Green Street may provide such valuation services to prospective acquirers of companies which are the subject(s) of Green Street's research reports.
- An affiliate of Green Street is the investment manager of an equity securities portfolio on behalf of a single client. The portfolio contains securities of issuers covered by Green Street's research department. The affiliate also acts as a sub-adviser to an outside Investment Management firm. The sub-advisor will develop and provide a suggested asset allocation model based on published research that is received from the research department. The affiliate is located in a separate office, employs an investment strategy based on Green Street's published research, and does not trade with Green Street's trading desk.

Other Important Information

Management of Conflicts of Interest Conflicts of interest can seriously impinge the ability of analysts to do their job, and investors should demand unbiased research. In that spirit, Green Street adheres to the following policies regarding conflicts of interest:

- Green Street employees are prohibited from owning the shares of any company in our coverage universe.
- Green Street employees do not serve as officers or directors of any of our subject companies.
- Green Street does not commit capital or make markets in any securities.
- Neither Green Street nor its employees/analysts receives any compensation from subject companies for inclusion in our research.
- Green Street does not directly engage in investment banking or underwriting work with any subject companies.

Please also have regard to the Affiliate Disclosures listed above when considering the extent to which you place reliance on this research report and any research recommendations made herein.

A number of companies covered by Green Street research reports pay an annual fee to receive Green Street's research reports. Green Street may periodically solicit this business from the subject companies. In the aggregate, annual fees for GSA (US) and GSA (UK) research reports received from subject companies represent approximately 3% of each of GSA (US)'s and GSA (UK)'s respective total revenues.

Green Street publishes research reports covering issuers that may offer and sell securities in an initial or secondary offering. Broker-dealers involved with selling the issuer's securities or their affiliates may pay compensation to GSA upon their own initiative, or at the request of Green Street's clients in the form of "soft dollars," for receiving research reports published by Green Street.

The information contained in this report is based on data obtained from sources we deem to be reliable; it is not guaranteed as to accuracy and does not purport to be complete. This report is produced solely for informational purposes and is not intended to be used as the primary basis of investment decisions. Because of individual client requirements, it is not, and it should not be construed as, advice designed to meet the particular investment needs of any investor. This report is not an offer or the solicitation of an offer to sell or buy any security.

Green Street Advisors is an accredited member of the Investorside[sm] Research Association, whose mission is to increase investor and pensioner trust in the U.S. capital markets system through the promotion and use of investment research that is financially aligned with investor interests.

Green Street generally prohibits research analysts from sending draft research reports to subject companies. However, it should be presumed that the analyst(s) who authored this report has(/have) had discussions with the subject company to ensure factual accuracy prior to publication, and has(/have) had assistance from the company in conducting due diligence, including visits to company sites and meetings with company management and other representatives.

Certified Provider

This report is a property-sector review and does not contain the amount of in-depth company-specific analysis sufficient to make informed investment decisions about one specific issuer disclosed in this report. For a more thorough analysis, please review this report in conjunction with GSA's company-specific research which is available at www.greenstreetadvisors com.

Terms of Use

Protection of Proprietary Rights To the extent that this report is issued by GSA (US), this material is the proprietary and confidential information of Green Street Advisors, Inc., and is protected by copyright. To the extent that this report is issued by GSA (UK), this material is the proprietary and confidential information of Green Street Advisors (U.K.) Limited, and is protected by copyright.

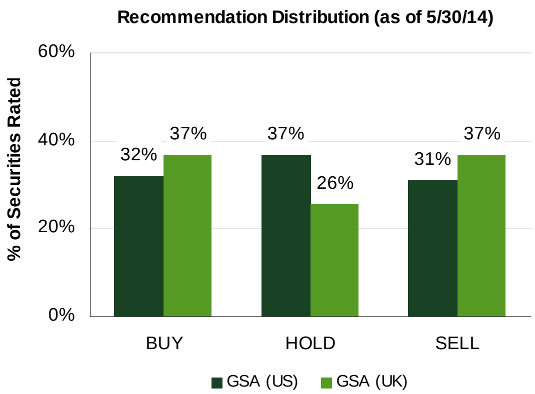
This report may be used solely for reference for internal business purposes. This report may not be reproduced, re-distributed, sold, lent, licensed or otherwise transferred without the prior consent of Green Street. All other rights with respect to this report are reserved by Green Street.

EEA Recipients For use only by Professional Clients and Eligible Counterparties GSA (UK) is authorized by the Financial Conduct Authority of the United Kingdom to issue this report to "Professional Clients" and "Eligible Counterparties" only and is not authorized to issue this report to "Retail Clients", as defined by the rules of the Financial Conduct Authority. This report is provided in the United Kingdom for the use of the addressees only and is intended for use only by a person or entity that qualifies as a "Professional Client" or an "Eligible Counterparty". **Consequently, this report is intended for use only by persons having professional experience in matters relating to investments. This report is not intended for use by any other person. In particular, this report intended only for use by persons who have received written notice from GSA (UK) that he/she/it has been classified, for the purpose of receiving services from GSA (UK), as either a "Professional Client" or an "Eligible Counterparty". Any other person who receives this report should not act on the contents of this report.**

Review of Recommendations
- Unless otherwise indicated, Green Street reviews all investment recommendations on at least a monthly basis**.**
- The research recommendation contained in this report was first released for distribution on the date identified on the cover of this report.
- Green Street will furnish upon request available investment information supporting the recommendation(s) contained in this report.

Green Street's Disclosure Information

At any given time, Green Street publishes roughly the same number of "BUY" recommendations that it does "SELL" recommendations.



Green Street's "BUYs" have historically achieved far higher total returns than its "HOLDs", which, in turn, have outperformed its "SELLs".

Year	Buy	Hold	Sell	Universe[3]
2014 YTD	17.7%	14.6%	10.8%	14.4%
2013	4.1%	0.6%	1.7%	2.2%
2012	24.5%	24.7%	18.9%	23.0%
2011	18.9%	7.6%	-4.7%	7.6%
2010	43.3%	32.8%	26.6%	33.8%
2009	59.0%	47.7%	6.0%	37.9%
2008	-28.1%	-30.9%	-52.6%	-37.3%
2007	-6.9%	-22.4%	-27.8%	-19.7%
2006	45.8%	29.6%	19.5%	31.6%
2005	26.3%	18.5%	-1.8%	15.9%
2004	42.8%	28.7%	16.4%	29.4%
2003	43.3%	37.4%	21.8%	34.8%
2002	17.3%	2.8%	2.6%	5.4%
2001	34.9%	19.1%	13.0%	21.1%
2000	53.4%	28.9%	5.9%	29.6%
1999	12.3%	-9.0%	-20.5%	-6.9%
1998	-1.6%	-15.1%	-15.5%	-12.1%
1997	36.7%	14.8%	7.2%	18.3%
1996	47.6%	30.7%	18.9%	32.1%
1995	22.9%	13.9%	0.5%	13.5%
1994	20.8%	-0.8%	-8.7%	3.1%
1993	27.3%	4.7%	8.1%	12.1%
Cumulative Total Return	**10566.3%**	**856.2%**	**1.8%**	**961.4%**
Annualized	**24.5%**	**11.2%**	**0.1%**	**11.7%**

The results shown in the table in the upper right corner are hypothetical; they do not represent the actual trading of securities. Actual performance will vary from this hypothetical performance due to, but not limited to 1) advisory fees and other expenses that one would pay; 2) transaction costs; 3) the inability to execute trades at the last published price (the hypothetical returns assume execution at the last closing price); 4) the inability to maintain an equally-weighted portfolio in size (the hypothetical returns assume an equal weighting); and 5) market and economic factors will almost certainly cause one to invest differently than projected by the model that simulated the above returns. All returns include the reinvestment of dividends. Past performance, particularly hypothetical performance, can not be used to predict future performance.

(1) Results are for recommendations made by Green Street's North American Research Team only (includes securities in the US, Canada, and Australia). Uses recommendations given in Green Street's "Real Estate Securities Monthly" from January 28, 1993 through May 23, 2014. Historical results from January 28, 1993 through October 1, 2013 were independently verified by an international "Big 4" accounting firm. The accounting firm did not verify the stated results subsequent to October 1, 2013. As of October 1, 2013, the annualized total return of Green Street's recommendations since January 28, 1993 was: Buy +24.5%, Hold +10.9%, Sell -0.3%, Universe +11.5%.

(2) Company inclusion in the calculation of total return has been based on whether the companies were listed in the primary exhibit of Green Street's "Real Estate Securities Monthly". Beginning April 28, 2000, Gaming C-Corps and Hotel C-Corps, with the exception of Starwood Hotels and Homestead Village, were no longer included in the primary exhibit and therefore no longer included in the calculation of total return. Beginning March 3, 2003, the remaining hotel companies were excluded.

(3) All securities covered by Green Street with a published rating that were included in the calculation of total return. Excludes "not rated" securities.

Per NASD rule 2711, "Buy" = Most attractively valued stocks. We recommend overweight position; "Hold" = Fairly valued stocks. We recommend market-weighting; "Sell" = Least attractively valued stocks. We recommend underweight position.

North American Team

Green Street Advisors

Research 660 Newport Center Drive, Suite 800 Newport Beach, CA 92660 +1.949.640.8780		
Research	Mike Kirby, Director of Research	mkirby@greenst.com
	Craig Leupold, President	cleupold@greenst.com
Health Care/Lab Space	Michael Knott, CFA, Managing Director	mknott@greenst.com
	Kevin Tyler, Senior Associate	ktyler@greenst.com
	Christina Zhang, Associate	czhang@greenst.com
Industrial/Towers	Eric Frankel, Analyst	efrankel@greenst.com
	Dillon Essma, Associate	dessma@greenst.com
Lodging	Lukas Hartwich, CFA, Senior Analyst	lhartwich@greenst.com
	Jonathan Taylor, CPA, Associate	jtaylor@greenst.com
Mall	Daniel Busch, Senior Analyst	dbusch@greenst.com
	Spenser Allaway, Associate	sallaway@greenst.com
Net Lease	Cedrik Lachance, Managing Director	clachance@greenst.com
	Tyler Grant, CFA, Associate	tgrant@greenst.com
Office/Data Centers	Jed Reagan, Senior Analyst	jreagan@greenst.com
	John Bejjani, CFA, Analyst	jbejjani@greenst.com
	Bayle Smith, Associate	bsmith@greenst.com
	Katherine Corwith, Associate	kcorwith@greenst.com
Residential/Self-Storage	Dave Bragg, Managing Director	dbragg@greenst.com
	Ryan Burke, Analyst	rburke@greenst.com
	David Segall, Senior Associate	dsegall@greenst.com
	Conor Wagner, Senior Associate	cwagner@greenst.com
	John Pawlowski, Associate	jpawlowski@greenst.com
Strip Centers	Jason White, CFA, CPA, Analyst	jwhite@greenst.com
	Jay Carlington, CFA, Senior Associate	jcarlington@greenst.com
Real Estate Analytics/Quant	Andrew McCulloch, CFA, Managing Director	amcculloch@greenst.com
	Jason Moore, CFA, Manager	jmoore@greenst.com
	Peter Rothemund, CFA, Analyst	prothemund@greenst.com
	Kawika Tarayao, CFA, Analyst	ktarayao@greenst.com
	Joi Mar, Senior Associate	jmar@greenst.com
	Matt Larriva, Senior Associate	mlarriva@greenst.com
	Casey Thormahlen, Associate	cthormahlen@greenst.com
	Amul Bhatia, Associate	abhatia@greenst.com

Subscription Sales & Marketing 660 Newport Center Drive, Suite 800 Newport Beach, CA 92660 +1.949.640.8780		
Sales	Damon Scott, Managing Director, Subscription Sales	dscott@greenst.com
	Kevin Johnson, Manager, Subscription Sales	kjohnson@greenst.com
Marketing	Rosemary Pugh, Manager, Marketing	rpugh@greenst.com

Advisory & Consulting 660 Newport Center Drive, Suite 800 Newport Beach, CA 92660 +1.949.640.8780		
	Jim Sullivan, Managing Director	jsullivan@greenst.com
	Dirk Aulabaugh, Managing Director	daulabaugh@greenst.com
	Matthew Wokasch, CFA, Senior Vice President	mwokasch@greenst.com
	Phillip Owens, CFA, Senior Vice President	powens@greenst.com
	David De La Rosa, Vice President	ddelarosa@greenst.com
	Justin Brown, Senior Associate	jbrown@greenst.com
	Dawn Seo, Senior Associate	dseo@greenst.com
	Adam Goldblatt, Associate	agoldblatt@greenst.com

Administration 660 Newport Center Drive, Suite 800 Newport Beach, CA 92660 +1.949.640.8780		
	Warner Griswold, CFA, Chief Operating Officer	wgriswold@greenst.com
	Michael Kao, Managing Director, Technology	mkao@greenst.com
	Robyn Francis, Manager, Compliance	rfrancis@greenst.com
	Jimmy Meek, Controller, Accounting	jmeek@greenst.com

Brokerage services offered through Green Street Trading

Trading & Institutional Sales 600 North Pearl Street, Suite 2310 Dallas, TX 75201 1.800.263.1388 (Trading) +1.214.855.5905 (Sales)		
Trading	Michael Vranich, Managing Director, Trading	mvranich@greenstreettrading.com
	Laurie Hauck, Vice President, Trading	lhauck@greenstreettrading.com
	Scott Lee, Vice President, Trading	slee@greenstreettrading.com
	Hayden Glasstetter, Trading Associate	hglasstetter@greenstreettrading.com
Institutional Sales	Anthony Scalia, Director, Institutional Sales	ascalia@greenstreettrading.com
	Tim Joy, Vice President, Institutional Sales	tjoy@greenstreettrading.com
	Scott Bell, Vice President, Institutional Sales	sbell@greenstreettrading.com
	Seth Laughlin, Vice President, Institutional Sales	slaughlin@greenstreettrading.com
	Kris Hoffman, Vice President, Institutional Sales	khoffman@greenstreettrading.com
	Eric Lovett, Institutional Sales	elovett@greenstreettrading.com

** These employees operate in a support capacity and are not yet registered representatives/research analysts. All employees listed in the "Research" section without an asterisk (*) are registered representatives/research analysts.*

PUBLIC COMPANY ADVISORY

JULY 27, 2010

Dodd-Frank Wall Street Reform and Consumer Protection Act - Public Company Impact

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The Act is aimed in part at accountability and transparency in the financial system and represents the most comprehensive financial reform legislation since the Great Depression. The Act also includes a number of provisions relating to executive compensation, corporate governance, credit ratings agency reforms and other matters that generally apply to public companies. This Advisory describes these provisions of the Act and how they may impact publicly traded companies.

Executive Compensation

The Act includes several provisions relating to executive compensation, which are summarized below. These include provisions relating to "say on pay," "say on golden parachute pay," independence of compensation committee members, independence of compensation committee advisors, additional executive compensation disclosures (pay vs. performance and internal pay comparison), clawback of erroneously awarded compensation and disclosure regarding employee and director hedging.

Say on Pay [§ 951]

The Act provides for say on pay for shareholders of all public companies. Under the Act, each company must give its shareholders the opportunity to vote on the compensation of its executives at least once every three years. The vote will be non-binding and will take the form of a resolution submitted to shareholders to approve the compensation of the company's executives as disclosed in the company's proxy statement. The frequency of the say-on-pay vote (i.e., every one, two or three years) will be determined by a separate shareholder vote at least once every six years. The Act permits the SEC to exempt companies or classes of companies from these requirements, taking into account, among other factors, whether the requirements disproportionately burden small companies.

It is important to note that this provision of the Act does not modify the executive compensation disclosure required in companies' proxy statements to require any additional disclosure of current or expected future compensation. Accordingly, as the say-on-pay vote will relate to the executive compensation that is disclosed in the proxy statement, it will primarily relate to historical compensation focusing on the compensation paid for or awarded during the prior year.

Effective Date: Companies must submit the say-on-pay vote and the vote to determine the frequency of future say-on-pay votes to their shareholders at the first annual meeting (or other shareholder meeting for which executive compensation disclosure is required in the proxy statement) occurring on or after January 21, 2011. As a result, most companies with a calendar year end will be required to submit these votes to their shareholders at their 2011 annual meetings.

Say on Golden Parachute Pay [§ 951]

In addition to the required say-on-pay votes, the Act also adds disclosure and voting requirements for golden parachute compensation that is payable to named executive officers in connection with sale transactions. These requirements apply to shareholder meetings at which shareholders are asked to approve a merger, consolidation, or sale of all or substantially all of the company's assets. In the proxy materials for such a meeting, the company soliciting proxies will be required to disclose, in a clear and simple form in accordance with regulations to be adopted by the SEC, any agreements or understandings with any named executive officer concerning any type of compensation (whether present, deferred or contingent) that is based on or otherwise relates to the transaction and the aggregate total of all such compensation that may (and the conditions upon which it may) be paid or become payable to or on behalf of such executive officer. In addition, unless such agreements and understandings have already been subject to a say-on-pay vote, the company must give its shareholders a non-binding vote on such agreements and understandings and total compensation at the meeting for the transaction.

The Act permits the SEC to exempt companies or classes of companies from these requirements, taking into account, among other factors, whether the requirements disproportionately burden small companies.

Effective Date: These new requirements will apply to any meeting of shareholders at which shareholders are asked to approve a merger, consolidation, or sale of all or substantially all of the company's assets occurring on or after January 21, 2011.

Independence of Compensation Committee Members [§ 952]

The Act provides that the SEC must issue rules directing the stock exchanges (i.e., national securities exchanges and associations) to prohibit listing classes of equity securities if the company's compensation committee members are not independent. Under the Act, the SEC's rules must require the stock exchanges to consider the following in defining independence for compensation committee members: (i) sources of compensation for each compensation committee member, including any consulting, advisory or other compensatory fee paid by the company to the member, and (ii) whether the compensation committee member is affiliated with the company. This requirement is similar to the heightened independence standards that were placed on audit committee members by the Sarbanes-Oxley Act, except that the SEC rules to be adopted under the Act only require the stock exchanges to *consider* the factors described above in determining the independence standards for compensation committee members whereas the Sarbanes-Oxley Act effectively required the stock exchanges to *prohibit* persons from serving on the audit committee who (i) receive any consulting, advisory or other compensatory fee from the company or (ii) are affiliated with the company. However, if the stock exchanges adopt compensation committee independence rules that parallel current audit committee independence rules (which they might) then otherwise independent directors who are currently prohibited from serving on the audit committee will also be prohibited from serving on the compensation committee.

Once final SEC and stock exchange rules are adopted, companies will need to reevaluate the composition of their compensation committees to ensure that they meet whatever heightened independence standards are adopted.

These new requirements do not apply to controlled companies (i.e., companies where 50% of the voting power is held by an individual, a group or another company), foreign private issuers that provide annual disclosures to shareholders of the reasons they do not have an independent compensation committee or open-ended management investment companies that are registered under the Investment Company Act of 1940. In addition, the SEC rules must permit the stock exchanges to exempt categories of companies from these requirements and, in determining appropriate exemptions, the stock exchanges must take into account the potential impact of the requirements on smaller reporting companies.

Effective Date: The SEC is required to adopt rules by July 16, 2011 directing the stock exchanges to prohibit the listing of any securities of a company that is not in compliance with these requirements.

Independence of Compensation Committee Advisors [§ 952]

The Act provides that a company's compensation committee may only select a compensation consultant, legal counsel or other advisor after taking into consideration factors to be identified by the SEC that affect the independence of a compensation consultant, legal counsel or other advisor. These will include the following five specific factors identified in the Act:

- the provision of other services to the company by the person that employs the compensation consultant, legal counsel or other advisor[1];
- the amount of fees received from the company by the person that employs the compensation consultant, legal counsel or other advisor, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel or other advisor;
- the policies and procedures of the person that employs the compensation consultant, legal counsel or other advisor that are designed to prevent conflicts of interest;
- any business or personal relationship of the compensation consultant, legal counsel or other advisor with a member of the compensation committee; and
- any stock of the company owned by the compensation consultant, legal counsel or other advisor.

The Act does not require companies' compensation committees to make formal independence determinations with respect to any compensation consultant, legal counsel or other advisor that it engages, but it does require each company to disclose in its proxy materials for its annual meetings, in accordance with regulations of the SEC, whether its compensation committee retained or obtained the advice of a compensation consultant and whether the work of the compensation consultant raised any conflict of interest and, if so, the nature of the conflict and how it is being addressed. Under current rules, companies are already required in their proxy statements to identify any compensation consultants used in determining or recommending the amount or form of executive or director compensation and include some disclosure relating to potential conflicts of interest of such compensation consultants. However, as the current rules do not appear to squarely address all of the new disclosure requirements of the Act, we expect the SEC to adopt additional rules relating to the disclosure of conflicts of interest.

The Act also requires that (i) the compensation committee be directly responsible for the appointment, compensation and oversight of the work of a compensation consultant, independent legal counsel and any other advisor that it retains and (ii) companies provide appropriate funding as determined by the compensation committee for payment of reasonable compensation to a compensation consultant, independent legal counsel or any other advisor to the compensation committee. However, the Act does not require the compensation committee to retain a compensation consultant, independent legal counsel or any other advisor, and it does not prohibit the compensation committee from receiving advice from a compensation consultant, legal counsel or other advisor to the company that was not specifically selected or retained by the compensation committee.

These new requirements do not apply to controlled companies (i.e., companies where 50% of the voting power is held by an individual, a group or another company). In addition, the SEC rules must permit the stock exchanges to exempt categories of companies from these requirements and, in determining appropriate exemptions, the stock exchanges must take into account the potential impact of the requirements on smaller reporting companies.

Effective Date: The proxy disclosure requirements described above apply to proxy materials for annual meetings occurring on or after July 21, 2011, provided that no specific deadline is set for the additional SEC regulations that appear to be contemplated by the Act regarding these disclosure requirements. The SEC is required to adopt rules by July 16, 2011 directing the stock exchanges to prohibit the listing of any securities of a company that is not in compliance with these requirements.[2] Lastly, the SEC is directed to identify factors that affect the independence of a compensation consultant, legal counsel or other advisor, but there is no specific deadline placed on the SEC for the identification of such factors.

Additional Executive Compensation Disclosures (Pay vs. Performance and Internal Pay Comparison) [§ 953]

The SEC is required under the Act to issue rules obligating companies to disclose in proxy materials for annual meetings of shareholders information that shows the relationship between executive compensation actually paid to their named executive officers and their financial performance, taking into account any change in the value of the shares of the company's stock and any dividends or distributions. The SEC is also required to amend Item 402 of Regulation S-K to require each company to disclose the median of total annual compensation for all employees of the company except the CEO, the total annual compensation of the CEO and the ratio of these two figures. Total compensation for the employees of a company will be calculated on the same basis as it is for purposes of the Summary Compensation Table required by Item 402 of Regulation S-K (i.e., including salary, bonus, grant date fair value of equity awards, perks, etc.). Depending on the number of employees a company has and the complexity of its compensation arrangements, among other things, determining the median of total annual compensation for all employees other than the CEO may impose a substantial additional administrative burden on the company.

Effective Date: Neither the date by which the SEC must adopt these rules nor the date by which any such rules must become effective is specified in the Act.

Clawback of Erroneously Awarded Compensation [§ 954]

The Act provides that the SEC must issue rules directing the stock exchanges to prohibit listing any security of a company unless the company develops and implements a policy providing (i) for disclosure of the policy of the company on incentive-based compensation that is based on financial information required to be reported under the securities laws and (ii) that, in the event that the company is required to prepare an accounting restatement due to the material noncompliance of the company with any financial reporting requirement under the securities laws, the company will recover from any current or former executive officer of the company who received incentive-based compensation (including stock options awarded as compensation) during the three-year period preceding the date on which the company is required to prepare the restatement based on the erroneous data, any excess compensation above what would have been paid under the restatement. This clawback requirement is significantly broader than the clawback contained in the Sarbanes-Oxley Act, which, among other things, only applied to restatements that resulted from misconduct and only applied to a company's CEO and CFO.

Due to the draconian nature of the clawback required, this provision of the Act may lead companies to consider restructuring their incentive-based compensation to either (i) include a deferral feature to reduce the amount of compensation that is paid out prior to the expiration of the clawback period, (ii) move more towards discretionary incentive-based compensation programs or (iii) utilize non-financial metrics such as stock price appreciation or total return to shareholders.

Effective Date: Neither the date by which the SEC must adopt these rules nor the date by which the stock exchanges must have adopted rules addressing these requirements is specified in the Act.

Disclosure Regarding Employee and Director Hedging [§ 955]

The Act requires the SEC, by rule, to require that each company disclose in the proxy materials for its annual meetings whether any employee or board member is permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange traded funds) designed to hedge or offset decreases in the market value of equity securities granted as compensation or otherwise held by the employee or board member. As a result, companies that do not already have a comprehensive policy addressing the use of hedging instruments, whether in their insider trading policies and procedures or elsewhere, may want to consider adopting one.

Effective Date: Neither the date by which the SEC must adopt these rules nor the date by which any such rules must become effective is specified in the Act.

Corporate Governance

The Act includes several provisions relating to corporate governance, which are summarized below. These include provisions relating to proxy access, disclosure of Chairman and CEO structure, and broker discretionary voting.

However, in the area of general public company corporate governance, perhaps the most notable part of the Act is what is not included. The Act does not mandate majority voting in uncontested director elections, declassified boards or independent chairmen of the board, all of which had been in previously proposed legislation that was supplanted by the Act.

Proxy Access [§ 971]

The Act clarifies that the SEC may, but is not required to, promulgate rules that would require that a company's proxy materials include a nominee for the board of directors submitted by a shareholder. The Act also gives the SEC the authority to exempt companies or classes of companies from these requirements and specifically directs the SEC to consider whether the requirements would disproportionately burden small issuers. Prior versions of the Act (and its predecessors) had included limitations on the SEC's ability to adopt proxy access (e.g., limiting the shareholders entitled to access to those who had held at least 1% of a company's stock for at least two years). The most notable feature of this provision of the Act is that it does not include any such limitation and gave the SEC full flexibility to determine the parameters of proxy access. The SEC's latest proposal regarding proxy access, from June 2009, was summarized in Goodwin Procter's July 2, 2009 Public Company Advisory.

Effective Date: July 21, 2010.

Disclosure of Chairman and CEO Structure [§ 972]

Pursuant to the Act, the SEC must issue rules requiring companies to disclose in their annual proxy sent to investors the reasons why the company has the same person serving as chairman of the board and CEO or has different individuals serving in those roles. Given that Item 407 of Regulation S-K already requires companies to disclose their board leadership structure along with an explanation of why the company selected the structure, it is unclear what additional steps will need to be taken, if any, in response to this provision.

Effective Date: The SEC is required to issue rules by January 17, 2011 regarding this disclosure requirement.

Broker Discretionary Voting [§ 957]

The Act requires stock exchanges to have rules prohibiting their members (i.e., brokers) from voting securities that they do not beneficially own (unless they have received voting instructions from the beneficial owner) with respect to the election of a member of the board of directors (other than an uncontested election of directors of an investment company registered under the Investment Company Act of 1940), executive compensation or any other significant matter, as determined by the SEC by rule. The potential impact of the restriction on discretionary voting for directors by brokers should have already been determined by most companies given the recent amendment to NYSE rules eliminating discretionary voting for director elections for annual meetings of shareholders held on or after January 1, 2010. NYSE rules have also prohibited discretionary voting by brokers on many of the most typical matters relating to executive compensation, such as the adoption or amendment of an equity compensation plan. As a result, for most companies, this provision of the Act should not have a significant impact on their shareholder voting.

Effective Date: July 21, 2010. The Act does not specify a date by which the SEC must adopt rules identifying any "other significant matters" with respect to which discretionary voting must be prohibited (or even if the SEC must adopt any such rules).

Credit Ratings Agency Reforms [§§ 931 et seq.]

The Act includes a number of provisions that are targeted at improving the reliability of credit ratings. The precise impact of these reforms on companies and credit ratings agencies will not be fully known until the numerous additional rules the Act has charged the SEC with adopting and implementing have been promulgated. However, it does appear that these reforms could have a significant impact. Please note that the foregoing does not address the specific implications of the provisions of the Act relating to credit ratings agency reform as they apply to offerings of asset-backed securities.

One of the significant provision of the Act, in this respect, is the repeal of Rule 436(g) under the Securities Act of 1933, as amended (the "Securities Act"), which had provided that a credit rating disclosed in a registration statement (including any prospectus) was not considered an expertized portion of the registration statement requiring written consent of the applicable credit ratings agency for inclusion. In theory, this would require companies to either obtain the consent of the credit ratings agency or exclude the credit rating from the registration statement. However, because consenting to the inclusion of the credit rating would subject the ratings agency to potential liability under Section 11 of the Securities Act, the credit ratings agencies have indicated that they will not be willing to provide their consent. As a result, generally, companies will be required to exclude credit ratings from their registration statements (including any prospectuses) unless and until the credit ratings agencies change their positions. However, companies will still be permitted to refer to a credit rating orally, in a free writing prospectus or in communications complying with Rule 134 under the Securities Act, without obtaining the consent of the applicable credit rating agency and, therefore, the framework for offering rated debt securities as it currently exists (other than with respect to asset-backed securities) should not be effected materially by this change. In addition, the SEC has issued interpretive guidance confirming that companies (i) may still include disclosure of credit ratings if the disclosure is related only to changes to a credit rating, the liquidity of the company, the cost of funds for the company or the terms of agreements that refer to credit ratings[3] and (ii) may continue to use registration statements that were declared effective before July 22, 2010 that included or incorporated by reference credit ratings without obtaining the consent of the applicable credit ratings agency until the next required amendment of the registration statement pursuant to Section 10(a)(3) of the Securities Act[4], provided that no subsequently incorporated periodic or current report contains ratings information other than that described in clause (i) above.

The reforms also include several provisions that will change the type of information provided by credit ratings agencies and may change the type of information provided by public company issuers to credit ratings agencies. For example, the Act will require credit ratings agencies to publicly disclose additional information regarding the data relied upon to determine a credit rating and information on uncertainty of such credit rating (including information on the reliability, accuracy and quality of the data relied on in determining such credit rating and any limits on the accessibility to information that would have better informed such credit rating). Additionally, the SEC is directed to revise Regulation FD to remove the blanket exemption for a public company's disclosure to entities whose primary business is the issuance of credit ratings. Therefore, a public company will have to determine whether a disclosure to a given credit ratings agency is a disclosure that is subject to Regulation FD, and if it is, whether another exemption, such as the exemption that permits material non-public information to be shared with a person who expressly agrees to maintain the disclosed information in confidence, may be relied upon.

The Act also requires the SEC, along with all other federal agencies, to modify all of its regulations to remove any reference to or requirement of reliance on credit ratings and to substitute an alternative standard of credit-worthiness that is deemed appropriate by the SEC. Among other things, this would require the SEC to replace the Form S-3 eligibility requirement relating to the issuance of non-convertible securities that are "investment grade securities." The SEC has previously proposed replacing this eligibility requirement with an alternative requirement that would be satisfied by companies that had issued at least $1 billion in aggregate principal amount of non-convertible securities, other than common equity, for cash (not exchange) in registered offerings in the prior three years. If this previously proposed standard is adopted, it would exclude a number of companies, such as operating partnerships of REITs that have not met this volume threshold, from using Form S-3 to publicly issue investment grade debt securities.

Effective Date: Generally, final regulations with respect to the credit ratings reforms are to be issued by the SEC by July 21, 2011. The SEC is required to revise Regulation FD by October 19, 2010. The repeal of Rule 436(g) is effective on July 21, 2010.

Various Other Provisions

The Act includes several other provisions that will impact public companies that are summarized below. These include provisions relating to a revised accredited investor standard, exemption for non-accelerated filers from Section 404(b) of the Sarbanes-Oxley Act, Section 13 and 16 reporting, reporting of short sales and certain votes by institutional investment managers and securities litigation matters.

Revised Accredited Investor Standard [§ 413; § 926]

The Act directs the SEC to make certain adjustments to the accredited investor standard relating to a natural person's net worth under the Securities Act, including for purposes of Regulation D. Regulation D provides a safe harbor for securities offerings that meet certain requirements from the registration requirements of the Securities Act. Under the most commonly used Regulation D exemption, offers and sales of securities are only exempt if, among other things, (i) there are no more than 35 purchasers in the offering who do not qualify as accredited investors and (ii) the company furnishes each purchaser in the offering who is not an accredited investor with detailed disclosure similar to that required in a registered offering. As a result, the definition of who qualifies as an accredited investor is very important, and companies routinely limit sales in private placements to investors who qualify as accredited investors.

The existing accredited investor standard relating to a natural person's net worth, which is one of the ways a natural person may qualify as an accredited investor, provides that a natural person will qualify as an accredited investor if his or her net worth (or joint net worth with his or her spouse) at the time of purchase exceeds $1,000,000. The Act changes the net worth standard to "$1,000,000, excluding the value of the primary residence of such natural person" during the four-year period that begins on July 21, 2010, which is the date of enactment of the Act. Although this change was effective on the date of enactment, the Act also directs the SEC to adopt rules that will incorporate this change and permits the SEC to review and adjust other accredited investor standards for natural persons. The Act also directs the SEC to review and authorizes the SEC to adjust the definition of accredited investor in its entirety, as it applies to natural persons, at least once every four years to determine whether the definition should be adjusted or modified for the protection of investors and in light of the economy, provided that any adjustment to the net worth standard must be to an amount more than $1,000,000, excluding the value of the natural person's primary residence.[5] Companies intending to complete a private placement in reliance on this exemption after July 21, 2010 may need to take additional steps to ensure that this exemption will be available for offerings that were not closed before July 21, 2010.

In a separate provision, the Act also directs the SEC to issue rules to disqualify certain "bad actors" from participating in a private placement that is intended to satisfy the most commonly used Regulation D exemption (i.e., Rule 506 exemption).

Effective Date: The change in the accredited investor net worth standard is effective as of July 21, 2010. The SEC is required to issue rules by July 21, 2011 regarding the disqualification of "bad actors."

Exemption for Non-Accelerated Filers from Section 404(b) of the Sarbanes-Oxley Act [§ 989G]

The Act amends Section 404 of the Sarbanes-Oxley Act by exempting non-accelerated filers (i.e., generally, those companies with less than $75 million of non-affiliate common equity market capitalization) from the requirements to provide an independent auditor attestation of management's assessment of the effectiveness of the company's internal control over financial reporting. These companies will still be required to maintain internal control over financial reporting and assess the effectiveness of their internal controls on an annual basis. Previously, the SEC had temporarily delayed the application of this requirement to non-accelerated filers several times. This amendment will provide some much appreciated certainty on this issue for non-accelerated filers. The Act also requires the SEC to conduct a study to determine how it could reduce the burden of Section 404(b) of the Sarbanes-Oxley Act on companies with market capitalization between $75 million and $250 million.

Effective Date: July 21, 2010.

Section 13 and Section 16 Reporting [§ 929R; § 766]

The Act eliminated the requirement under Section 13(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), for persons filing a Schedule 13D to send copies to the issuer and the exchanges on which such securities are listed and the requirement under Section 16 of the Exchange Act for reporting persons to file their Section 16 reports with any national securities exchange on which the underlying securities are registered. The Act also modified Section 13(d) and Section 16 to permit the SEC to require persons to make their initial filings under these sections (i.e., Schedule 13Ds or Form 3s, respectively) within less than 10 days of the triggering event (i.e., becoming a 5% or greater shareholder or becoming a director, officer or 10% shareholder).

The Act also amends Section 13 of the Exchange Act to provide that a person will be deemed to have acquired beneficial ownership of an equity security for the purposes of Section 13 or Section 16 based on the purchase or sale of a security-based swap only to the extent that the SEC by rule, after consultation with banking regulators and the Treasury, makes certain determinations regarding the security-based swap and its comparability to the underlying security. The Act then amends Section 13(d), Section 13(f) and Section 13(g) of the Exchange Act to provide that such deemed beneficial ownership will be considered beneficial ownership of the underlying equity securities for purposes of the reporting requirements contained in those subsections.

Effective Date: July 21, 2010.

Reporting of Short Sales and Certain Votes by Institutional Investment Managers [§ 929X; § 951]

The Act requires the SEC to prescribe rules providing for monthly or more frequent public disclosure of short sales by institutional investment managers who are currently subject to reporting under Section 13(f) of the Exchange Act. Additionally, the Act requires these institutional investment managers to disclose their votes on say on pay and say on golden parachute pay at least annually unless they are otherwise required to report such votes publicly. These rules may provide additional insight to companies regarding shorting of their securities and how certain institutional investors voted on the new say-on-pay votes.

Effective Date: The provision relating to the reporting of say-on-pay votes is effective on July 21, 2010; however, as it only relates to annual reporting of votes required under the Act (which are only required for meetings occurring on or after January 21, 2011), the first reporting may not occur until late 2011 or early 2012. With respect to the rules regarding the disclosure of short sales, the Act does not specify the date by which the SEC must adopt such rules or the date by which they must become effective.

Securities Litigation Matters

The Act also has a number of provisions designed to promote the SEC's and private litigants' litigation efforts, including, among others, the following:

- establishing aiding and abetting liability for persons who knowingly or recklessly provide substantial assistance to another person in violation of the Securities Act with respect to civil actions brought by the SEC under certain provisions of Section 20 of the Securities Act;

- changing the liability standard for aiding and abetting liability with respect to civil actions brought by the SEC under certain provisions of Section 21(d) of the Exchange Act to includes persons who "recklessly" provide substantial assistance to another person in violation of the Exchange Act in addition to persons who do so "knowingly";

- increasing whistleblower protections relating to violations of securities laws and allowing whistleblowers to collect a portion of monetary sanctions collected by the SEC relating to the matter the whistleblower provided information regarding; and

- the addition of specific anti-fraud prohibitions relating to short sales.

Please note that this Advisory does not necessarily describe the specific impact of each of the provisions of the Act summarized above on voluntary filers, foreign private issuers, asset-backed issuers, registered investment companies and others subject to unique requirements.

---

[1] Presumably, where the compensation consultant, legal counsel or other advisor is a firm or other entity, the phrase "the person that employs the compensation consultant, legal counsel or other advisor" is intended to refer to such firm or other entity.

[2] Note that the Act does not explicitly limit the application of these provisions to companies listed on stock exchanges (or state that they don't otherwise apply to all companies as of July 21, 2010). However, based on the provisions relating to the stock exchanges and their ability to exempt certain companies (among other things), we do not believe that the Act should be construed in this manner.

[3] This position is consistent with the preliminary position that the SEC articulated in a concept release issued in 2009 relating to the potential repeal of 436(g).

[4] For registration statements on Form S-3, a Section 10(a)(3) updating amendment will occur upon the filing of a company's annual report on Form 10-K.

[5] As written, this requirement only applies to the accredited investor definition under Rule 215 under the Securities Act and not the definition for purposes of Regulation D. However, we believe it is likely that the SEC will review and adjust both at the same time.

If you would like additional information about the issues addressed in this Client Advisory, please contact:

Daniel Adams	dadams@goodwinprocter.com	617.570.1966
Marian Tse	mtse@goodwinprocter.com	617.570.1169
Scott Webster	swebster@goodwinprocter.com	617.570.8229
Lisa Haddad	lhaddad@goodwinprocter.com	617.570.8311
James Barri	jbarri@goodwinprocter.com	617.570.1105
Ettore Santucci	esantucci@goodwinprocter.com	617.570.1531
Lynda Galligan	lgalligan@goodwinprocter.com	617.570.1090
John O. Newell	jnewell@goodwinprocter.com	617.570.1475
David Roberts	droberts@goodwinprocter.com	617.570.1039

I. Public company structure vs. private equity fund model

A. REITs Generally[1]

Real estate investment trusts (REITs) are entities that satisfy certain U.S. federal income tax requirements and elect to be taxed as REITs. In general, the tax requirements ensure that the REITs (a) are passive investors in real estate (and related assets), (b) do not retain their earnings, and (c) are beneficially owned by a diversified stockholder base.

REITs can be publicly traded or privately held as long as they satisfy the organization and operational requirements for REIT status, as described below. The three general types of REITs are:

- publicly traded REITs
- public non-traded REITs and
- private REITs.

The Internal Revenue Code sets forth the requirements for each type of REIT.

B. Public REITs[2]

REITs become public companies in the same way as non-REITs, although there are additional disclosure obligations for REITs and compliance with certain rules regarding roll-ups may be required. Public REITs (both traded and non-traded) are subject to reporting and other requirements of public companies under the federal securities laws. Publicly traded REITs are subject to additional regulatory requirements of their exchanges, such as the NYSE. Some REITs also may be able to take advantage of more lenient requirements available to emerging growth companies under the Jumpstart Our Business Startups (JOBS) Act of 2012.

---

[1] Matthew Hudson. Funds: Private Equity, Hedge and All Core Structures, (John Wiley & Sons) (2014).

[2] Nilene R. Evans et al., Frequently Asked Questions About Real Estate Investment Trusts, Morrison& Foerster LLP (2013), *available at* http://www.mofo.com/files/Uploads/Images/FAQ_REIT.pdf.

1. Publicly Traded REITs[3]

Publicly traded REITs must comply with securities laws and regulations that apply to all public companies, as well as the disclosure requirements of Form S-11 and SEC Industry Guide 5 of the Securities Act of 1933, as amended (the "Securities Act"), and in some cases, Section 14(h) of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Securities and Exchange Commission ("SEC") rules specify the disclosures to be made in a prospectus for a public offering of securities, as well as for ongoing disclosures once an issuer becomes a public company. For most initial public offerings by a U.S. domestic entity, Form S-1 sets forth the required disclosures. REITs, however, must use Form S-11 and include information responsive to SEC Industry Guide 5. In addition to the same kinds of disclosures required by Form S-1, Form S-11 sets forth the following additional disclosure requirements:

- Investment policies regarding investments in real estate, mortgages and other real estate interests based on the REIT issuer's prior experience in real estate;

- Location, general character and other material information regarding all material real properties held or intended to be acquired by or leased to the issuer or its subsidiaries ("material" is defined in this case as any property whose book value is 10% or more of the total assets of the consolidated issuer or the gross revenues from which is at least 10% of aggregate gross revenues of the consolidated issuer for the last fiscal year);

- Operating data of each improved property, including the occupancy rate, number of tenants and principal lease provisions; and

[3] *Id.*

- Arrangements with respect to the management of the REIT's real estate and the purchase and sale of mortgages for the REIT issuer.

SEC Industry Guide 5 contains the following additional requirements:

- Disclose risks relating to (i) REIT management's lack of experience or lack of success in real estate investments, (ii) uncertainty if a material portion of the offering proceeds is not committed to specified properties, and (iii) real estate limited partnership offerings in general;

- Disclose the general partner's or sponsor's prior experience in real estate; and

- Disclose risks associated with specified properties, such as competitive factors, environmental regulation, rent control regulation, fuel or energy requirements and regulations.

REITs listed on a securities exchange are generally subject to the same rules as non-REITs. For a REIT that does not have a three-year operating history, however, the NYSE typically will permit listing if the REIT has at least $60 million in stockholders' equity, including the funds raised in any IPO related to the listing.

Publicly traded REITs have historically exhibited price volatility in correlation with broader equity markets.[4] Similarly, distribution yields paid by traded REITs vary with the movement in stock price in addition to the value of the assets held by the REIT itself.[5]

---

[4] Dr. Randy Anderson, Investing in Non-Traded REITs (Investment Program Association) (June, 2013), *available at:* http://www.ipa.com/?wpdmact=process&did=MzQzLmhvdGxpbms=.
[5] *Id.*

2. Public Non-Traded REITs[6]

Public non-traded REITs have offered securities to the public pursuant to the Securities Act and are subject to the ongoing disclosure and other obligations under the Exchange Act, but are not listed on a stock exchange. According to Blue Vault Partners, which tracks non-traded REITs, there were 69 non-traded REITs with an estimated $78.60 billion in assets as of June 30, 2013. Through the first eight months of 2014, non-traded REITs had raised in excess of $10 billion.[7] Shares of non-traded REITs generally are sold directly or through brokers and their prices are set by the REIT sponsor or may be based on net asset value as determined by independent valuation firms. Shares in non-traded REITs are available only to qualified investors, and the success of a non-traded REIT is measured by total return, including cash distributions during the lifespan of the REIT and any appreciation of principal realized as the result of a liquidity event.[8] Up-front fees for non-traded REITs range from 12% to 15%.[9]

As described above, exchange-traded REITs and non-traded REITs are both publicly registered, but shares of non-traded REITs are not listed and do not trade on a national securities exchange. As a result, shares of non-traded REITs typically have limited secondary markets and generally are significantly less liquid than exchange-traded REIT securities. As a result, investors can typically expect to hold shares in a non-traded REIT for the lifespan of the REIT, which is typically seven to ten years.[10] The life cycle of a non-traded REIT consists of four distinct phases: capital raising, property acquisition, asset management, and disposition (which may include a decision to list the REIT on a

---

[6] Evans et al., Frequently Asked Questions About Real Estate Investment Trusts.
[7] Robbie Whelan, Report Finds Non-Traded REITs Trail Publicly Listed Peers, The Wall Street Journal (Sep. 4, 2014), *available at:* http://blogs.wsj.com/developments/2014/09/04/report-finds-non-traded-reits-trail-publicly-listed-peers/.
[8] Dr. Randy Anderson, Investing in Non-Traded REITs.
[9] *Id.*
[10] *Id.*

public exchange).[11] Non-traded REITs are obligated to execute an exit strategy to return invested capital and any appreciation to investors, which also poses a unique risk.[12]

Because of the limited market in securities of non-traded REITs, the industry standard in the past was to set the initial offering price at $10 per share and to maintain it at that level, sometimes for many years, irrespective of the operating performance of the issuer. The Financial Industry Regulatory Authority, Inc. ("FINRA") also recently proposed revisions to Rule 2340 regarding per share estimated valuations for unlisted REITs, which were approved by the SEC on October 10, 2014, as described below.[13] In some cases, non-traded REITs may have limited annual redemption programs to provide some liquidity to investors. Such redemption programs are costly to investors in that they always are at a discount from the purchase price, and they also are typically limited by the number of shares that may be redeemed and may be suspended if market conditions dictate.[14]

The SEC, FINRA and others have scrutinized non-traded REITs because of allegedly high upfront and continuing fees paid to the sponsor and its affiliates, as well as the fact that the share price (which is based on the net asset value calculated by the REIT sponsor) generally does not change even with changes in the issuer's operating results or related matters, such as calculation of dividend yields and appreciation.[15] For example, some non-traded REITs have paid dividends out of proceeds from issuing debt without correspondingly decreasing net asset values in their holdings, giving an illusion of a stable price.[16] Critics of non-

---

[11] *Id.*
[12] *Id.*
[13]SEC Release No. 34-73339; File No. SR-FINRA -2014-006 (October 10, 2014).
[14] *Id.*
[15] *See also* FINRA Regulatory Notice 09-09 (Feb., 2009), *available at*: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117795.pdf.
[16] Tim Husson, PhD et. al., A Primer on Non-Traded REITs and Other Alternative Real Estate Investments (Securities Litigation & Consulting Group) (2012), *available at:*

traded REITs claim that positioning them as investments that don't have volatility is also misleading to investors because they are not traded and therefore volatility cannot be measured.[17] Additionally, it is not uncommon for non-traded REITs to have conflicts of interest due to commonalities of key individuals and entities.[18]

In October 2011, FINRA issued an investor alert[19] to warn investors of certain risks of publicly registered non-traded REITs, including:

- Distributions are not guaranteed and may exceed operating cash flow (the REIT's board of directors, in its discretion in exercising its fiduciary duties, decides whether to pay distributions and the amount of any distribution);
- Investors may suffer adverse tax consequences resulting from distributions and REIT status;
- There is no public trading market, which results in illiquidity and valuation complexities;
- Early redemption features often are restrictive and may be expensive;
- Fees may be significant;
- REIT's properties may not be specified; and
- Possible lack of diversification.

---

http://www.slcg.com/pdf/workingpapers/Non%20Traded%20REITs%20White%20Paper.pdf.

[17] Robbie Whelan, Non-Traded REITs Trail Publicly Listed Peers.

[18] Tim Husson, PhD et. al., A Primer on Non-Traded REITs and Other Alternative Real Estate Investments.

[19] Public Non-Traded REITs—Perform a Careful Review Before Investing, (Financial Industry Regulatory Authority, Inc.), *available at:* http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/REITS/P124232.

In August 2012, FINRA reissued an alert to inform investors of the features and risks of publicly registered non-traded REITs.[20] FINRA also provides investors with tips to deal with these risks. On July 16, 2013, the SEC also issued guidance regarding disclosures by non-traded REITs on distributions, dilution, redemptions, estimated value per share or net asset value, supplemental information, compensation to sponsor, and prior performance, among other things.[21]

C. Private REITs[22]

Like other companies, REITs may issue equity securities without registration under the Securities Act if there is an available exemption from registration, such as Section 4(a)(2) of the Securities Act (often in accordance with Regulation D) or Regulation S or Rule 144A under the Securities Act.

Unlike public REITs, private REITs are subject to restrictions on how many shareholders they may have, although they must have at least 100 holders. Section 12(g) of the Exchange Act requires a company to register under the Exchange Act and be subject to its periodic reporting and other obligations if it has at least 2,000 shareholders of record or 500 shareholders who are not accredited investors, and the Investment Company Act requires registration of investment companies that have more than 100 holders who are not qualified purchasers unless another exemption is available. In addition, the equity securities of private REITs are not traded on public stock exchanges, and generally have less liquidity than those of publicly traded REITs.

To satisfy ownership and holder requirements, a typical private REIT structure has one or a handful of shareholders who may own

---

[20] *Id.*

[21] SEC Staff Observations Regarding Disclosures of Non-Traded Real Estate Investment Trusts, CF Disclosure Guidance: Topic No. 6 (July 16, 2013), *available at*: http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic6.htm.

[22] Evans et al., Frequently Asked Questions About Real Estate Investment Trusts.

all the common stock, along with a special class of preferred shares owned by at least 100 holders in order to satisfy the requirement of having at least 100 shareholders. A private REIT also must satisfy the "not closely held" requirement. In most cases, however, the "not closely held" requirement is not an issue because the holders of shares in a private REIT will be corporations or partnerships with many investors. The "not closely held" rule is applied by looking through those entities to their investors. In some cases, special considerations may apply when direct or indirect shareholders are tax-exempt.

Alternatively, some companies provide services to help a private REIT fulfill the 100 shareholder requirement. Such companies also may provide administrative service relating to ownership and holder requirements, including maintaining the shareholder base, creating and maintaining shareholder records and keeping records of the ownership changes.

II. Recent SEC staff guidance and areas of focus, including implications for capital raise transactions

A. Valuation Rules Change for Non-Listed REITs

On October 10, 2014, the SEC approved a FINRA-proposed revision to NASD Rule 2340 regarding per share estimated valuations for unlisted REITs.[23] FINRA first submitted the proposed rule changes in January 2014. The rule will become effective 18 months after the approval date (April 10, 2016). Key rule changes include:[24]

- Firms must include a per-share estimated value for an unlisted direct participation program or a REIT on customer statements using one of two methodologies presumed to be reliable: (1) net investment methodology (reflecting the "net investment" disclosed in the issuer's

[23] SEC Release No. 34-73339; File No. SR-FINRA-2014-006 (October 10, 2014).
[24] "SEC Valuation Rule Changes for Non-Listed REITS," Duff & Phelps (October 2014).

most recent periodic or current report, based on the amount available for investment percentage shown in the offering prospectus), or (2) appraised value methodology (consisting of the appraised valuation disclosed in the issuer's most recent periodic or current report). Under the net investment methodology, firms also have to spell out to customers in a statement that part of their distribution includes a return of capital, and any distribution that represents a return of capital reduces the estimated per-share value shown on the customer's account statement.

- Non-listed REIT issuers must include general disclosures: (1) there is no liquid market for the REIT securities; (2) even if a shareholder is able to sell the security, the price received may be less than the per share estimated value provided in the customer statement; (3) what methodology was used to calculate the value reported, and (4) that the value reported was based on a reliable methodology.

- Net investment may not be used for more than two years plus 150 days after breaking escrow. Firms may not include an over distribution deduction in net investment methodology.

- Independent valuation methodology requires the firm to retain a third-party, independent valuation expert to perform or provide material assistance in the valuation beginning at a minimum of two years plus 150 days after breaking escrow. Firms also must update the valuation annually thereafter.

- The independent valuation must be accompanied by a written opinion or report by the issuer delivered annually to the broker-dealer that explains the scope of the review, the methodology used and the basis for the values reported.

B. SEC Guidance on Real Estate Acquisitions

On July 16, 2013, the SEC's Division of Corporation Finance posted an updated Financial Reporting Manual on the SEC's website. The Financial Reporting Manual reflects numerous substantive updates to the Staff's guidance on REIT disclosure issues related to real estate acquisitions. Effective immediately upon release, the Manual guidance includes updates regarding the application of Rule 3-14 of Regulation S-X, as well as confirmation that Rule 3-14 financials are not triggered at the time of a shelf takedown. The SEC also stated that in some cases, a REIT issuer may use pro forma assets to measure the significance of an acquisition for Rule 3-14 purposes.

C. SEC Guidance on Public Non-Listed REIT Disclosures

The SEC's Division of Corporation Finance also released guidance on non-traded REIT disclosures on July 16, 2013.[25] The guidance encourages non-traded REITs to streamline prior performance disclosure so that potential investors can accurately evaluate the business characteristics and economic position of the non-traded REIT. The Staff explains that prior performance disclosure should reflect "an appropriate balance between the benefits of providing investors useful prior performance disclosure and the risk that voluminous and complex prior performance disclosure may obscure other material information about the registrant."

According to the guidance, a non-traded REIT is required to disclose its ability to maintain or increase its historical distribution yield and the source of funds used to cover a shortfall if the cash flow cannot cover distributions. Newly formed non-traded REITs that have no distribution history should disclose estimated distribution yield, share values, and assets values in SEC filings, as well as the basis for their estimates. In addition, non-traded REITs should disclose any potential dilution that could affect the value of

---

[25]SEC Staff Observations Regarding Disclosures of Non-Traded Real Estate Investment Trusts, CF Disclosure Guidance: Topic No. 6 (July 16, 2013), *available at*: http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic6.htm.

shares and explain the dilutive impact of aggregate distributions paid in excess of earnings.

The guidance also indicates that non-traded REITs should disclose information about their redemption programs. Because investments in non-traded REITs are generally illiquid, many non-traded REITS provide investors with limited liquidity through their redemption programs. But such programs always have restrictions on the number of the shares that could be redeemed per year and the source of funds that could be used for redemptions. Therefore, the guidance asks the non-traded REITs to summarize their redemption history with a description of the number of requests honored, the number of requests deferred and the source of funds used to honor these request.

D. SEC Guidance on Conflict Minerals May Impact REITs

In May 2013, the SEC provided guidance on the new conflict minerals disclosure requirements that apply to public companies if conflict minerals are necessary to the production of a product that the company manufactures.[26] The guidance clarifies that the equipment used to provide services and retained by or returned to the company or intended to be abandoned by the customer following the term of the service is not "product" under the rule. This interpretation supports the conclusion that the development or redevelopment of real estate assets that are primarily held for lease are not subject to the conflict mineral disclosure requirements.

E. SEC Accounting Guidance Affecting REITS

In August 2013, the SEC published amendments to its Financial Reporting Manual to clarify and modify certain requirements related to the filling of financial statements by REITs.[27] The

[26] Dodd-Frank Wall Street Reform and Consumer Protection Act Frequently Asked Questions, *available at* http://www.sec.gov/divisions/corpfin/guidance/conflictminerals-faq.htm.
[27] Financial Reporting Manual, *available at* http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml.

amendments generally reduced the required financial statement disclosures. Key provisions include:

- "*Significant in the Aggregate*" *Acquisitions*: For purposes of evaluating individually insignificant acquisitions, REITs need only file the acquisitions since the latest audited year-end, not the acquisitions made during the last audited fiscal year.[28]

- *Triple Net Lease Properties*: If a REIT acquires a property subject to a triple net lease and such property represents a significant portion of the REIT's assets, the REIT must provide full audited financial statements of the lessee, co-lessee or guarantor. The term "significant portion" means a property exceeds 20% of the REIT's total assets as of the most recent balance sheet date. [29]

- *Shelf Takedowns*: The SEC clarified that Rule 3-14 financial statements are not triggered at the time of shelf takedown.[30]

- *Equity Investment*: If a REIT acquires an equity interest in a pre-existing legal entity that holds only real estate under lease/debt and the acquisition is significant, then the REIT needs to provide Rule 3-14 financial statements. If the pre-existing legal entity engages in other activities, however, then Rule 3-05 financial statements are required if the acquisition is significant.[31]

- *Real Estate Operations*: For purposes of Rule 3-14, "real estate operations" refer only to properties that generate revenue solely through leasing.[32]

---

[28] *Id.* § 2320. 2.
[29] *Id.* § 2340.
[30] *Id.* § 13110.2.
[31] *Id.* § 2305.3.
[32] *Id.* § 2305.2.

- *Pro Forma Financials*: The guidance permits REITs to use pro forma financial information to calculate the significance of a real estate acquisition made after the filling of a Form 8-K that includes historical audited financial statements for a prior significant acquisition.[33]

- *Rental History Less Than Nine Months*: The staff will accept unaudited financial statement if the REIT acquired operating property that has rental history of more than three months but less than nine months.[34] No financial statements are required if the leasing history is less than three month.[35]

- *Blind Pool Offering*: In determining significance for property acquired during the distribution period of a blind pool offering, the guidance is revised to allow a REIT to compare its investment in the property to total assets as of the date of the acquisition plus the proceeds (net of commissions) it expects to raise in the registered offering over the next 12 months.[36]

E. SEC Areas of Focus

Based on a review of various publicly available SEC comment letters issued to REITs regarding their SEC periodic and other filings during 2014, the Staff most frequently sought additional disclosure or explanation concerning:

- Use of non-GAAP financial measures;
- Related party/affiliate transactions;
- Leasing activity generally, including a comparison of rates on new or renewed leases to prior rates;
- MD&A disclosure regarding trends and recent market impacts, including the interest rate environment; and

[33] *Id.* § 2025.3.
[34] *Id.* § 2330.8.
[35] *Id.* § 2330.10.
[36] *Id*. § 2305.5.

- Assumptions used in arriving at certain financial statement amounts, including depreciation, amortization, interest expense, asset management fees, deferred financing costs, cash, accounts payable and accrued expenses, and due to affiliates.

F. Auditing Estimates and Fair Value Measurements

On October 31, 2014, the National Association of Real Estate Investment Trusts ("NAREIT") issued a letter in response to the solicitation for public comment by the Public Company Accounting Oversight Board ("PCAOB") with respect to the Staff Consultation Paper, *Auditing Estimates and Fair Value Measurements*, *August 19*, *2014* (the "Staff Paper").[37]

NAREIT suggests that a change to the existing audit framework for auditing estimates is not proper for two reasons. First, a single standard for auditing estimates and fair value measurement will not work because of the multiple iterations of GAAP accounting estimates. Second, the change will expand audit work without increasing the reliability or credibility of the audited financial statements. In NAREIT's view, the PCAOB fails to specify the underlying problem that would warrant a change in auditing standards. While NAREIT admits that there are shortcomings in the audit work surrounding estimates, it argues that those shortcomings could be caused by "auditor shortcomings relative to existing standards rather than problems with the auditing standards themselves."

NAREIT also objects to expanding the scope of audit work where a third party specialist or pricing service is used. In particular, NAREIT disagrees with the requirement that the auditor needs to test and evaluate the information or audit evidence obtained from third-party sources as if it were produced by the company. NAREIT argues that neither management of the company nor the

---

[37] A Letter to the PCAOB on the Staff Consultation Paper Auditing Estimates and Fair Value Measurements, National Association of Real Estate Investment Trusts, *available at* http://www.reit.com/nareit/policy-issues/financial-standards.

external auditor is able to evaluate third parties' processes and controls because (1) the third party specialists and pricing services are independent from the company, and (2) the estimates are based on many subjective factors that are not testable. In general, companies hire third parties to provide estimates because (a) the company does not have the time or expertise to perform the work, and/or (b) estimates of the third parties are more reliable and objective than the internal estimates. Requiring company management and the auditor to evaluate the third parties' processes and controls is not feasible, given the reasons above.

Finally, preparers, auditors and investors all understand that the estimates are not accurate and are based on the management's "knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take." The auditor's responsibility is to evaluate the reasonableness of the estimates, rather than to determine whether the estimates are correct or wrong.

NAREIT instead urges PCAOB, when considering changes to existing auditing framework, to use a targeted approach to address specific sections of audit guidance, rather than wholesale changes to the entire audit framework.

III. From private to public: considerations in planning an IPO

Like most companies, REITs must make legal and operational changes before moving forward with an initial public offering ("IPO") to sell securities to the public. The majority of corporate governance policies and procedures, federal securities law requirements and securities exchange requirements must be in place when the IPO registration statement is filed, as described below.

A. Why Go Public?

The primary reasons that REITs move from private to public companies include:

- Ability to raise money to expand operations

- Deleverage financing on existing property portfolios
- May increase market value
- Enables REIT to acquire other companies/properties
- Helps attract and retain employees
- Allows founders/shareholders to diversify personal holdings and provides exit strategy
- Provides liquidity for existing owners/shareholders
- Typically enhances REIT's reputation and business profile in the market

B. Disadvantages of Going Public

If a REIT has another way to raise capital, it may opt not to go public. An IPO is very expensive and there is no guarantee it will be successful. Typical IPO expenses include legal fees and accounting fees, filing fees, travel costs, printing costs and underwriters' discount and commission, among other things. The IPO process is also very disruptive to the REIT's day-to-day business.

Once the REIT is public, it will be subject to scrutiny from securities regulators and investors, particularly in the areas of executive compensation and related party transactions, among other things. Public REITs also must comply with securities law reporting requirements, which can be time-consuming and expensive. Public company officers and directors face increased liability risks for false or misleading statements in securities filings.

Another disadvantage is the potential for loss of some control. Ownership limitation provisions are common for REITs in order to protect REIT tax status. These provisions reduce the likelihood of hostile transactions; however, there is still a reduction in management’s control when operating in the public market.

Public REIT directors and officers also face a loss of privacy. The registration statement and subsequent reports require disclosure of many facets of the REIT's business, operations, and finances that may never before have been known outside the company. Sensitive Information will be available to competitors, customers, and employees, such as: (1) director and officer compensation; (2) security holdings of officers, directors, and major shareholders; (3) details of transactions, including filing of material contracts; and (4) extensive financial information (such as financial position, operating revenue, operating costs, net operating income, net income, segment data, related-party transactions, borrowings, cash flows, major tenants/customers, and assessment of internal controls).

Public companies also face constant pressure to increase earnings. Many investors have a short-term focus, hoping to sell stock quickly if the price increases. Shareholders expect steady growth in areas such as leasing, profits, market share and innovation. Management is under constant pressure to balance short-term demands for growth with strategies that achieve long-term results. If management is unable to meet analysts' expectations of short-term earnings, the marketplace's long-term valuation of the REIT will be diminished.

Directors and officers of public companies must balance this earnings pressure, along with the risk of takeover attempts by unhappy investors or rivals.

C. Key Issues to Consider With Advisers

When considering an IPO, a REIT's directors and officers should discuss the following types of key issues with their legal, financial and accounting advisers:

- Does our REIT have an attractive earnings and growth track record?
- Does our REIT have the necessary financial processes, internal controls and financial statement integrity to support Sarbanes-Oxley reporting obligations?
- When and on which exchange to launch the IPO?

- What are the relevant regulatory requirements for an IPO on the desired exchange and can the REIT meet them?
- Will the REIT need to change its corporate structure, its capital structure and/or its management team?
- What are the chances of a successful IPO?
- Will selling stockholders be allowed to participate in the IPO and/or in the over-allotment option?
- Will the REIT qualify as an emerging growth company (EGC)?
- If the REIT is an EGC, what exemptions and scaled disclosure accommodations may apply?

D. Key Participants in the IPO Process

The REIT's Board of Directors. SEC rules require that a majority of the REIT's directors sign the registration statement, so directors must be involved in the IPO process from start to finish. If directors are not involved, they may be unable to establish a due diligence defense and may have liability for material errors or omissions in the registration statement. In general, non-employee directors typically are not involved in the working group sessions, but they do review and comment on interim drafts of the registration statement. The REIT board typically forms a pricing committee comprised of one or two directors who have the authority to negotiate with the managing underwriters to establish the terms and conditions of the offering (including pricing terms). In preparing the REIT for an IPO, REIT directors and officers should review current board composition with its attorneys and investment bankers to ensure that the REIT complies with all rules and regulations applicable to public companies.

Investment Banker/ Lead Manager. The lead investment bank manages the IPO process and coordinates with the REIT's other advisers. Depending on the terms of its engagement, the lead investment bank typically assumes some or all of the roles below. The lead manager(s) makes the major decisions regarding the structure, allocation, timing and pricing of the offering, the drafting of the registration statement and the timing and content of the road show. The managing underwriters may coordinate a larger group of investment banks (referred to as the "underwriting syndicate") to help distribute the stock and bear the risk of the offering. The lead manager and co-managers are the main members of the underwriting syndicate involved in the IPO preparation process, drafting sessions and the road show.

Underwriter. The lead investment bank and one or more other underwriters typically underwrite the offering. The majority of IPOs are made with firm commitment underwriters. In a firm commitment offering, the REIT sells the IPO shares to the underwriters at a discount to the price at which the shares are sold to the public. The underwriters then either sell the stock directly or through other members of a selling group, to investors who subscribe to the offering.

Financial Adviser. Financial advisers work with REIT directors and officers on, among other things, the timing of the IPO, the structure of the offering(s), the REIT's capital structure, the REIT's board composition, corporate governance, the marketing strategy and process, valuation and pricing issues and any arrangements with principal shareholder(s).

Stabilizing Manager. If an offering includes stabilization (a process in which the lead underwriter supports the market price of the securities in order to prevent or slow down a decline in the price of the securities), the lead underwriter typically assists in that process. To accomplish stabilization, the lead underwriter generally buys and sells securities in the open market, normally by means of an over-allocation of the securities. Stabilization creates the impression that there is demand for the securities at a particular price or at various prices. This practice promotes orderly operation of the market, helps reduce investor anxiety, meets demand and counteracts short selling

Counsel for the Company and the Selling Stockholders.
If there are no conflicts of interest, the same law firm may act as securities counsel for the company and any selling stockholders. In many cases, however, selling stockholders require separate legal counsel, especially when there are conflicts of interest between the

REIT and selling stockholder. The REIT's law firm has numerous responsibilities throughout the IPO process, including:

- If necessary, reorganizing the structure of the REIT.
- Coordinating and conducting due diligence.
- Drafting the registration statement and ensuring compliance with the requirements of the securities laws.
- Filing or confidentially submitting the registration statement with the SEC.
- Coordinating, drafting and filing responses to SEC comments on the registration statement.
- Preparing and submitting the securities exchange listing application.
- Negotiating the underwriting agreement.
- Assisting the company with implementing the necessary corporate governance structures.
- Advising the board of directors of their role throughout the IPO process.
- Advising the company about the many on-going reporting and other disclosure obligations imposed by the securities laws and the securities exchanges.

Counsel for the Underwriters. Underwriters' counsel is responsible for:

- Assisting the underwriters in satisfying their due diligence obligations.
- Participating in the drafting process.
- Obtaining FINRA clearance of the underwriting arrangements.
- Complying with applicable state securities laws and regulations.
- Drafting and negotiating the underwriting agreement.
- Coordinating the closing with the REIT's counsel.

Company's Auditors. The REIT's auditors ensure that the financial information included in the registration statement complies with the SEC financial disclosure requirements, which in some cases differ from and are more extensive than US GAAP. Other auditor responsibilities include:

- Providing a comfort letter to the underwriters and the REIT's board of directors confirming that the financial statements contained in the registration statement comply with accounting requirements, and tying the tables and other financial information included in the registration statement to the financial statements and other financial records of the REIT.
- Participating in the due diligence process relating to the financial statements, pro forma financial information (if any) and management's discussion and analysis.
- Identifying significant accounting issues that may warrant a pre-filing conference with the SEC.

Public Relations Consultants. A public relations (PR) firm can play a valuable role in the success of an IPO. By generating positive publicity for the REIT prior to the IPO, PR consultants can help ensure that potential investors are made aware of the REIT and its properties. However, this process must be carefully monitored by legal counsel to avoid violations of the SEC rules. After the IPO, ongoing press interest can help sustain awareness of the REIT and liquidity in its shares.

E. Preparing for the IPO

1. Corporate Structure

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

2. Timing Issues

REIT IPOs typically take somewhat longer than other types of IPOs. In general, the IPO process may take between three to eight months, depending on, among other things, the REIT's readiness to go public, market conditions, the time necessary to complete required audits of the financial statements for property acquisitions, and the availability of the information that must be disclosed in the registration statement. For a successful, orderly IPO, begin planning and acting like a public company at least one and possibly two years before the desired IPO launch date.

3. Corporate Documents

REIT management and legal advisers must examine the company's organizational documents to determine whether they are suitable for a public company, focusing on the following:

- Remove any anachronistic provisions, such as pre-emptive rights and rights of first refusal
- Remove any restrictions on stock transfers
- Delete all unneeded provisions (close corporations)
- Alter special voting provisions, class votes
- Consider anti-takeover provisions (supermajority voting for certain transactions; remove action by written consent or ability to call special meeting; put poison pill in place; ability for board to amend the bylaws without stockholder approval)

4. Corporate Governance

Public companies generally must comply with each provision of the Sarbanes-Oxley Act of 2002. In order to prepare for the IPO, private companies should consider complying with the following provisions of the Sarbanes-Oxley Act several months before launching the IPO:

Internal controls. The public REIT's management (CEO and CFO) must provide certain certifications in SEC periodic filings regarding the company’s internal controls. In addition, on an annual basis, the external auditor is required to audit the company’s internal controls over financial reporting. To prepare for the applicable public company internal controls certifications, REIT management should establish, document, and monitor compliance of executing internal controls at least one year before launching the IPO, if possible.

*Board committees***.** Public companies must have independent audit committee members, including one qualified as a financial expert, as well as compensation committees and nominating committees. REITs considering an IPO should form such committees in advance, prepare committee charters and make certain the members of the committees meet SEC and securities exchange requirements.

Board of directors/trustees. The majority of the directors/trustees must be truly independent, as defined by SEC and securities exchange rules. In addition, at least one board member must have a financial background—either as a CPA or as a previous CFO. The Board also must meet in executive session. A REIT board considering an IPO should evaluate its board membership criteria, policies and practices to ensure that it is functioning as a public company board before launching the IPO.

Independent auditor. A public company's external auditor cannot provide certain nonaudit services, including but not limited to internal audit, legal, and valuation services. In addition, permissible nonaudit services must be preapproved by the audit committee. REITs should evaluate their existing relationship with outside audit firms to ensure compliance and SEC and exchange rules.

Code of ethics. Public companies must establish a code of ethics. A REIT planning an IPO should establish a code of ethics in advance to demonstrate diligence and compliance in preventing corporate misconduct.

Loans to executives. Public companies cannot extend or maintain credit in the form of personal loans to or for any director or executive officer. A REIT planning an IPO should adopt policies to make prohibit such loan arrangements.

5. Director and Officer Insurance/Indemnification

Private company D&O insurance typically does not cover securities offerings, such as an IPO. A REIT considering an IPO should review its D&O coverage and seek additional coverage for the public offering. In addition, the company should consider a separate form of officer and director indemnification agreement providing that the company will indemnify each of its directors and officers to the fullest extent permitted by its organizational documents and the laws of the state of its incorporation.

6. Management and Employees

Employment arrangements for members of management and key employees must be in a form that is suitable for a publicly listed company. In the months before the IPO, the REIT Compensation Committee should work with management on such employment agreements, as well as incentive compensation plans. Once the REIT is public, certain provisions of the federal securities laws will apply to the REIT's benefit plans. The REIT also should consider setting up an employee stock purchase plan if it has not already done so.

7. Other Corporate Matters

Banking Facilities. Any banking facilities or other financing arrangements of the REIT need to be reviewed to ensure that they are sufficient for its capital requirements as a publicly listed company (taking into account the proceeds of any new issue of shares). The underwriters may suggest that the company enter into a banking facility prior to the IPO to ensure that the company will have sufficient capital following the IPO.

Contracts. Important contracts need to be reviewed to ensure that there are no change of control or other provisions which would be triggered by the IPO and which could have an adverse effect on the business of the company. While conducting due diligence, company counsel should review all contracts to ensure that the company owns all relevant assets and that these are not held, for example, by stockholders. There also may be commercial arrangements to be entered into between the company and its stockholders which may not have been formalized, such as for the provision of services and the use of property.

IV. REIT Spin-offs, Conversions and Alternative Capital Structures

A. REIT Spin-offs/Separation Transactions[38]

Many companies have significant real estate holdings in connection with their businesses. While holding real estate gives a company control over critical operation assets, it also ties up capital and often requires significant management attention. A potential way to tax-efficiently unlock the value of a company's real estate is to separate the company into a REIT that owns the company's real estate and a separate operating company. Contractual relationships including leases can be set up between the operating entity and the REIT to allow the business to continue to utilize the real estate on acceptable terms.

REIT separation transactions can be complicated, especially as a result of the requirements for tax-free treatment and the requirements that the resulting entity must satisfy in order to enjoy treatment as a REIT. To ensure tax-free treatment, the following criteria must be satisfied, among others:

- There must be a non-tax business purpose for the separation.
- Following the spin-off, the REIT has to be involved in an "active trade or business."
- The REIT may not have any earnings or profits from the period prior to becoming a REIT.

Examples of recent REIT separation transactions include: Penn National Gaming's creation of the first-ever casino REIT in 2013; Simon Property's separation of its strip center and smaller enclosed malls businesses into a REIT in 2014; and CBS's 2014 IPO of CBS Outdoor Americas.

[38] Gregory E. Ostling and David K. Lam, Spin Offs: The Decision to Separate and Considerations for the Board (Practical Law The Journal: Transactions & Business) (Sep. 2014).

A parent (non-REIT) entity that owns a corporate subsidiary that could qualify as a REIT can distribute or spin-off the subsidiary stock to its shareholders.[39] After the distribution or spin-off, the subsidiary can elect to be taxed as a REIT.[40] At least one publicly traded company announced plans to convert to REIT status by spinning off its real estate assets into a publicly traded REIT and at least one other announced plans to explore the possibility of creating a REIT for its real estate assets.[41]

To qualify as a tax-free transaction, a spin-off must meet the following general rules:

- Both parent and the subsidiary must have been engaged in an active trade or business before and after the spin-off ("active business requirement");
- There must be an independent business reason for the spin-off ("business purposes requirement").

Even if the spin-off would otherwise meet the requirements of a tax-free transaction, it should be noted that to qualify as a REIT after a spin-off the subsidiary must disgorge earnings and profits from the time period prior to becoming a REIT. Furthermore, a corporate tax on the excess of the value of assets over their tax basis will apply to the REIT if its sells assets within ten years of the REIT conversion.

If the general spin-off requirements above are met, a REIT can also spin-off a subsidiary to its shareholders in a tax-free transaction. However, the incentive to qualify the spin-off as tax-

---

[39] Micah W. Bloomfield and Mayer Greenberg, REITs: Overview (Practical Law Company, Practice Note) (2011).
[40] *Id.*
[41] Cecile Daurat and Caitlin McCabe, Windstream to Spin Off Networks Into Publicly Traded REIT, Bloomberg (Jul. 29, 2014), *available at:* http://www.bloomberg.com/news/2014-07-29/windstream-to-spin-off-telecom-assets-into-publicly-traded-reit.html.; Sara Germano, Gym Owner Life Time Fitness Considers a REIT, The Wall Street Journal (Aug. 25, 2014), *available at:* http://online.wsj.com/articles/gym-owner-life-time-fitness-considers-a-reit-1408998441.

free may be reduced if the parent was always a REIT, as a REIT is not subject to tax on any gain recognized in the spin-off.

B. Mergers[42]

Two separate REITS can merge in either a taxable or a tax-free transaction. If common stock in the acquiring REIT comprises the sole consideration paid in the merger, the merger will generally qualify as a tax-free. As a result, the target REIT and its shareholders would not recognize any taxable gain or loss.

A merger may still qualify as tax-free if a "substantial portion" (35% to 40%) of the consideration is payable in stock, even if the remainder of the consideration is cash. In this case, shareholders would recognize gain to the extent of the cash consideration. If the stock received does not qualify as a "substantial portion," the merger is generally a taxable event. Therefore shareholders would recognize gain on the amount of cash and the value of stock received.

REIT mergers most commonly take the following forms:

- **Target REIT into acquiror REIT**. Whether the merger is taxable or tax-free depends on the amount of the cash consideration as described above. Because the target does not survive, approval for the transaction is likely required to maintain contractual relationships and regulatory licenses.
- **Target REIT into wholly-owned subsidiary of acquiror REIT**. Whether the merger is taxable or tax-free depends on the amount of the cash consideration as described above. Approval for the transaction is likely required to maintain contractual relationships and regulatory licenses.
- **Subsidiary of acquiror REIT into target REIT**. This is a taxable transaction. At least one industry group has requested a change to the IRS guidance governing this situation, which if adopted would make this the preferred

[42] Bloomfield and Greenberg, REITs: Overview.

form of tax-free merger as it likely would not require approval to maintain the contractual relationships and regulatory licenses.

- **Merger of REITs that are in the UPREIT format**. To qualify as tax-free, the merger must be completed in two steps: (i) a merger of the REITs, and (ii) a combination of the operating partnerships. How the operating partnerships are combined depends in part on whether any unit holders object to the merger and the provisions of the operating partnership agreement governing the approval procedures for mergers or asset sales. Additionally, some unit holders may have acquired units in exchange for contributions of property, which may implicate agreements containing tax protection provisions triggering certain rights upon the disposition of property.

C. REIT conversions[43]

The number of companies pursuing conversions from a regular taxable C-corporation to a REIT structure continues to increase. A REIT conversion can improve a company's tax efficiency as well as provide additional sources of capital. Because most REITs trade at higher multiples than taxable C-corporations a conversion can also increase shareholder value.

Reasons for increased interest in REIT conversions include:

- **Tax Benefits:** Converting to a REIT could avoid corporate-level taxation on REIT earnings that are distributed to shareholders. REITs generally avoid corporation tax because they are entitled to a dividends-paid deduction and must distribute 90% of ordinary income each year. However, unlike other pass-through entities, a REIT cannot pass-through the losses to its shareholders. Additionally, dividends paid by a REIT to an individual are not eligible for the lower rate of qualifying

[43] Micah W. Bloomfield and Daniel Martinez, REIT Conversions (Practical Law The Journal: Transactions & Business) (Oct. 2014).

dividend income, and instead are treated as ordinary income.

- **Relaxed REIT Qualification Requirements:** Over the past years, the general liberalization of the rules and definitions make it feasible for non-traditional real estate companies to consider REIT conversions. For example, the Housing Act of 2008 permitted REITs to engage in a broader range of transactions through the expansion of relevant definitions. The IRS has issued private letter rulings that have broadened the types of real properties to include cold-storage warehouses, telecommunications towers, billboards, data centers, casinos and private prisons. Additionally, the IRS published a proposed regulation in May, 2014 that provides a long non-exclusive list of property that could be considered as real property, including outdoor advertising displays and transmission lines.

- **Higher Valuations for REIT Stocks:** REIT stocks trade at higher multiples than stocks of C-corporations because they provide higher rewards to shareholders due to REIT qualification rules (they must distribute annually at least 90% of their income to shareholders). Therefore, converting to a REIT typically results in meaningful increases in stock prices.

D. REIT Conversion Requirements[44]

1. Organizational and Operational Requirements for REIT Status

To convert to a REIT, a company must meet the following organizational requirements: (a) be managed by trustees or directors; (b) be beneficially owned by 100 or more persons; (c) issue transferable shares or certificates; (d) be taxable as a US corporation; (e) not be a bank or an insurance company; and (f) not be more than 50% owned by five or fewer individuals.

[44] *Id.*

Additionally, the company must satisfy the following operational requirements: (a) 75% of its gross income must be related to real estate; (b) 95% of its gross income must be passive; (c) at least 75% of the value of the REIT's assets must be real estate, cash and government securities; (d) not more than 25% of the value of the REIT's assets can be represented by securities, other than securities included in the 75% asset test; and (e) may not own more than 10% of the total vote or value of the outstanding securities of any one issuer, and not more than 5% of a REIT's assets may be invested in the securities of one issuer.

As a result of the above organizational and operational requirements, a REIT conversion always requires a reorganization that splits the business into two or more parts.

2. Purging Earnings and Profits

A previously taxable corporation with accumulated earnings and profits that converts to a REIT must distribute its accumulated earnings and profits to shareholders before the end of its first taxable year. As a result, it is common for companies undergoing a REIT conversion to declare a special "purging" dividend in the first year of its qualification as a REIT.

The allocation of earnings and profits between the spun-off company and its parent company following a REIT conversion is subject to relevant Treasury regulations. For a newly formed spin-off, the earnings and profits are usually allocated proportionally to the fair market value of the businesses that are spun off and retained. In some cases, however, the allocation is made in proportion to the net tax basis of the assets transferred and retained. Special regulations also apply if the companies are part of a consolidated group. A company's REIT election could be deemed ineffective, making it be subject to corporate-level taxation, for failing to properly purge accumulated earnings and profits.

Because a purging dividend comes out of the company's available cash, it may be difficult for a company to issue an all-cash purging dividend. An alternative approved by the IRS in a private letter ruling is for the company to issue a taxable stock dividend, offering shareholders the right to elect to receive either cash or REIT shares, subject to a 20% limitation on the aggregate amount of cash distributed to all shareholders. Consequently, a company can purge $100 of accumulated earnings and profits by distributing $20 of cash and $80 of stock. This method of conserving cash has become common in REIT conversions.

3. Built-in Gains Tax

If a REIT acquires property from a C-corporation in a non-taxable transaction (including a non-taxable REIT conversion), the REIT may have to pay taxes on any appreciated assets with built-in gains if those assets are sold within ten years.

4. Other Issues in REIT Conversions

Companies also should consider the following additional impediments to REIT conversions:

- The organizational documents of the company electing REIT status need to be amended to restrict stock ownership to meet the REIT ownership requirements and avoid being closely-held (greater than 50% ownership by five or fewer individuals) and ensure the REIT has 100 or more shareholders. A good number of REITs are incorporated in Maryland to maximize enforceability of these provisions.[45]

- REIT organizational requirements may require that certain debt covenants be modified. Existing debt covenants may restrict dividend distributions, contrary to the requirement that REIT distribute most of its income. Furthermore, the existence of outstanding convertible debt may result in a potential violation of stock ownership requirements.

[45] Ameek Ashok Ponda, Key REIT Conversion Considerations (Sullivan & Worcester LLP) (2013), *available at:* http://www.sandw.com/assets/htmldocuments/Key%20REIT%20Conversion.pdf.

Making necessary modifications to existing debt arrangements may result in additional expenses to the company.

- Tax considerations accompanying a REIT election often require reclassification of some property from personal property (generally depreciable over five to seven years) to real property (generally depreciable over 39 years). This may result in significant tax liability because of the resulting recapture of depreciation and amortization expenses attendant with the reclassification of real estate.

- Compliance with asset and income tests, limitations on related tenants and independent contractor requirements all require increased recordkeeping and accounting.

- Existing dividend reinvestment plans, share repurchase plans and employee equity incentives may need to be reviewed to ensure compliance with REIT requirements.

- Existing lease agreements should be reviewed to ensure that the rent received qualifies as good rent to meet the REIT income test.

- All services provided should be reviewed to ascertain if they are customary or need to be performed by a taxable REIT subsidiary ("TRS"). TRSs should be adequately compensated at arms-length pricing for services provided to avoid redetermination of rents.[46]

E. REIT Conversion Structures[47]

There are three common ways to structure a REIT conversion.

- Internal restructuring with REIT election by the parent company.

[46] *Id.*
[47] Bloomfield and Martinez, REIT Conversions.

- Spin-off of REIT or operating subsidiary.
- Stapled ownership.

1. Internal Restructuring with REIT Election

The converting company places non-REIT assets and activities into a new subsidiary that will be classified as a TRS. The TRS will be subject to income taxes, although in its taxable income may be reduced by rent and other payments (including to third parties or to the REIT itself).

This structure is beneficial because the shareholders continue to own the entire business, including the real estate and the operating company. However, limitations on how much stock and debt can be held by the parent REIT restrict the circumstances in which this structure is feasible (the value of the securities of the TRS held by the parent REIT must be 25% or less of the assets of the parent REIT). Restrictions on rent from related parties also makes the structure feasible only for businesses deriving rent from unrelated parties, or for hotels and healthcare facilities that qualify for an exception from the related party rent rules.

2. Spin-off of REIT or Operating Subsidiary (PropCo/OpCo Structure)[48]

A second REIT conversion structure is to have the converting corporation place its assets into newly formed real estate and non-real estate subsidiaries. This can typically be accomplished tax-free, subject to some state and local transfer taxes. Either subsidiary can then be distributed or spun-off to shareholders. Following the spin-off, the real estate entity elects to be taxed as a REIT, and the operating entity ("OpCo") remains a taxable corporation. PropCo will then lease its real estate back to OpCo,

[48] *See also* Ed Liva and Greg Williams, Unlocking the Value Hidden in Real Estate Holdings: REIT Conversion Benefits (KPMG, LLC) (2013), *available at:* http://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/Documents/unlocking-value-hidden-real-estate-holdings.pdf.

and OpCo will pay tax-deductible rent payments to PropCo. These payments will not be subject to corporate-level tax as long as PropCo qualifies as a REIT. The related party limitations on rent do not apply as long as OpCo and PropCo do not have a shareholder that actually or constructively owns 10% of both companies, making this an advantageous alternative to other structures. However, separating the operations from the real estate assets, may not be the most economically efficient way to use the assets.

A transaction must meet strict requirements under IRC Section 355 to qualify as a tax-free spin-off. One of the requirements of a tax-free spin-off is that both the distributing and the distributed corporations must be engaged in an active trade or business for at least five years before the distribution. Additionally, there must be a valid corporate business purpose is a prerequisite to a tax-free spin-off, even if it is not the main purpose of the transaction. Importantly, a reduction in US federal income taxes does not qualify as a valid corporate business purpose. IRS staff has informally indicated that the intention to make a REIT election may in itself be a sufficient business purpose, particularly if the REIT intends to raise equity capital.

The IRS does not issue private letter rulings on whether there is a valid corporate business purpose, and instead such determination is made upon an examination of the taxpayer's return. Therefore, it is common for a company undergoing a REIT conversion through a spin-off to request a letter from an investment bank that describes the corporate business purpose for the transaction.

3. Stapled Ownership

In the final REIT conversion structure, the REIT is partially owned by a taxable C-corporation ("Parent"), and partially owned by other shareholders who are also the owners of Parent, and shares of the REIT trade together with shares of Parent as one unit. This structure allows Parent to keep assets and operations together and be controlled by the same management team, making it advantageous to the PropCo/OpCo structure. However, the shareholders receive less than half of the benefits of REIT ownership because more than 50% of the shares of the REIT are owned by a taxable corporation. As a result, this structure makes sense when it is important to keep assets and operations under common control, but where a TRS structure is not possible.

F. Recent Examples - Non-traditional REIT Conversions[49]

- GEO Group Inc. and Corrections Corporation of America, which own and operate correctional and detention facilities, each placed a small portion of their respective businesses not related to real estate into wholly-owned TRSs to achieve REIT status. GEO also had to divest all healthcare facility management contracts because of stringent rules pertaining to the operation and management of healthcare facilities by REITs.

- Penn National Gaming, Inc., which operates gaming and racing facilities, completed a tax-free spin-off of Gaming and Leisure Properties, Inc., which owns the real estate associated with 21 gaming facilities, and became the first REIT focused on gaming facilities.

- Iron Mountain Incorporated, a storage and information management services company received a favorable private letter ruling from the IRS on June 25, 2014 and will proceed with its REIT conversion by making a REIT election as of January 1, 2014.

- Windstream Holdings, Inc., a provider of advanced communications and technology solutions, including cloud computing and managed services, announced plans to separate its business into two publicly traded, independent companies. Windstream will reclassify its copper and fiber optic lines as real property assets and place them with other real property assets into a REIT. Windstream will retain operational control of the network assets via a long-term triple net exclusive master lease agreement.

[49] Bloomfield and Martinez, REIT Conversions.

NAREIT's Law, Accounting & Finance Conference

JW Marriott Desert Ridge Resort & Spa
Phoenix, AZ

®

NAREIT's REITwise 2015 - General Counsel Agenda Panel

General Counsel Agenda Panel

PANELISTS:	TOPICS:
Dan Adams, Goodwin Procter	1. In-house as Gatekeepers
Frank Burt, Boston Properties	2. Governance Risk & Compliance in 2015
Shirley Goza, QTS Realty Trust	3. Crisis Management Plans
Elizabeth Sacksteder, Paul Weiss	4. Enforcement Issues
	5. Dodd-Frank Claw Back Rules

In-house as Gatekeepers

What is risk/what are the components of risk?

- Financial
- Compensation
- Fraud
- Property/Casualty
- Third-Party Claims Liability
- Reputational
- M&A

Calculated Risk

- What is the role of economics?
- Integration of the lawyer as a member of the business team
- The creative legal solution—the lawyer as a value-add
- The business' responsibility for its own decisions

Where does compliance report in your organization?

- Legal?
- CEO?
- CFO?
- Board?
- Stand-Alone?
- Executive level?

Investigations

- Who should conduct them?
- Why or why shouldn’t legal conduct investigations?
- Who does investigations in your organization?

Governance Risk and Compliance in 2015

- How worried should a company be about their ISS or Greenstreet score?
- What do we know about the new ISS rules and how they've changed?
- What problems have people seen with the ISS methodology and its application?

Governance Risk and Compliance in 2015

- How is MUTA driven by Greenstreet in a way that is different from ISS?

- What are you seeing with regard to REITS being on the NY comptroller list (8/75).

Governance Risk and Compliance in 2015

ISS QuickScore 3.0 - New

- Annual Board Evaluation Policy
- Recent Board Action that "Materially Reduces" shareholders' rights?
- Number of women on Board - now scored
- Number of Financial Experts on Audit Committee – now scored
- If the company has an "unequal voting structure," does it have a sunset provision?
- Is there a controlling shareholder? (this is a zero-weight factor)

Governance Risk and Compliance in 2015

ISS Scoring Problems?

- Subjective weights?
- Peer group selection
- Less than 80% S/H vote for director
- Non-executive directors with more than 9 years of service
- Relativity of score – broad groups
- Total stockholder return (TSR) – financial rather than governance measure

Crisis Management Plans

- Anticipation of the unexpected
- The comprehensive crisis management plan
- Training

Enforcement Issues

- E-discovery – "threat of litigation"
- Section 16 Enforcement Actions
- NLRA "mutual aid and protection"
- Social media for Reg FD releases
- Non-deal roadshows

Dodd-Frank Claw Back Rules

- Policies being adopted prior to rule release?
- How do you drive the right incentives?

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 74240 / February 10, 2015

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3636 / February 10, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-16381

In the Matter of **WILLIAM SLATER, CPA and PETER E. WILLIAMS, III** **Respondents.**	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against William Slater and Peter E. Williams, III ("Respondents").

II.

In anticipation of the institution of these proceedings, the Respondents have submitted Offers of Settlement (the "Offers") that the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over each and over the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds[1] that:

Summary

1. This matter involves misstated revenues in the professional services organization at Saba Software, Inc. ("Saba" or "the Company"), a Silicon Valley-based enterprise software company. The misstatements were the result of the falsification of time records over a period of more than four years by professional services managers in multiple geographies directing consultants in Saba's Indian subsidiary (the India Consulting Group or "ICG") to falsify time records by either recording time in advance of performance of work or failing to record time for hours worked in order to achieve their quarterly revenue and margin targets.

2. As a result, Saba reported materially false financial results in its financial statements filed with the Commission over the period from October 4, 2007 through January 6, 2012. As Saba announced on August 6, 2012 and November 5, 2012, management has determined that the Company is required to restate its financial statements for fiscal years 2008 through 2011, as well as the first two quarters of fiscal 2012, as a result of misconduct. The Company expects that the restatement will change the time period during which the affected revenues are recognized, generally shifting the timing of such revenues to later periods.

3. Saba's former Chief Financial Officers, William Slater and Peter E. Williams, III, realized Saba stock-sale profits and received bonuses during the 12-month periods following the filings containing financial results that Saba is required to restate. The Commission does not allege that Slater and Williams participated in the misconduct giving rise to the restatement. Slater and Williams have not, however, reimbursed Saba for stock-sale profits and bonuses they are required to reimburse the Company under Section 304(a) of the Sarbanes-Oxley Act.

Respondents

4. **William Slater**, age 63, is a resident of San Diego, California. He served as Chief Financial Officer and Principal Accounting Officer of Saba from December 9, 2008 through October 27, 2011. He served as Chief Financial Officer, Vice President and Treasurer of another public company from November 10, 2011 to February 15, 2013. Slater was licensed as a certified public accountant in New York from 1978 to 2003, when his license became inactive.

5. **Peter E. Williams III**, age 53, is a resident of Hillsborough, California. Prior to joining Saba as General Counsel in October 1999, Williams was a partner at an international law

[1] The findings herein are made pursuant to Respondents' Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

firm. Williams has been Saba's Secretary from the time of the Company's inception in April 1997. Williams served as Saba's Chief Financial Officer and Principal Accounting Officer from March 2004 to July 2007 and then again, on an interim basis, from October 27, 2011 until January 7, 2012. Since July 2007, Williams has also served as Executive Vice President, Corporate Development. Williams has been licensed to practice law in California since 1987. He has never been licensed as a certified public accountant.

6. **Saba Software, Inc.** ("Saba" or "the Company") is a Delaware corporation headquartered in Redwood Shores, California. The software company provides cloud-based enterprise learning, talent management and social networking tools to businesses and large organizations. At all relevant times, Saba's common stock has been registered pursuant to Section 12 of the Exchange Act. From its IPO in April 2000 until July 31, 2006, its common stock was registered pursuant to Section 12(g). Thereafter, until June 2013, it was registered pursuant to Section 12(b). It traded on the Nasdaq Global Market until it was suspended on April 9, 2013, and then it was delisted effective June 17, 2013 for failure to remain compliant with its SEC reporting obligations. Upon its delisting and deregistration from Section 12(b), it reverted to its previous Section 12(g) registration. Its common stock is currently registered pursuant to Section 12(g) and traded on the OTC Markets. Saba has not filed any periodic reports since January 6, 2012, when it filed its Form 10-Q for the quarter ended November 30, 2011.

Facts

A. Saba's Falsification of Time Records

7. Saba's professional services historically have accounted for about one third of its approximately $120 million in yearly revenues. Professional services have been delivered to customers worldwide by (1) customer-facing field consultants in North America and Europe ("Field Consultants") and (2) off-shore technical development services provided to the Field Consultants by the Company's India Consulting Group ("ICG Consultants"). ICG is an organization within Saba's Indian subsidiary designed to help the Company deliver professional services to its customers at a lower cost than comparable consultants in North America and Europe. By 2011, ICG employed 50-60 consultants who generated approximately 14,000 hours of billable work per quarter, which constituted about 17% of consulting revenue and 6% of total revenue per quarter.

8. Both Field Consultants and ICG Consultants were required to record time worked on customer projects in a timesheet database. Hours input into the system by Field or ICG Consultants were approved on a weekly basis by project managers in North America and Europe, and revenue for the professional services organization was then measured based on the approved number of hours in the timesheet database.

9. Saba disclosed in its public filings that it recognized revenue for both "time and materials" and "fixed fee" contracts as the services were performed. This revenue recognition treatment was consistent with GAAP only if Saba could demonstrate that (1) its customers have historically paid a consistent rate for its services (measured by Vendor Specific Objective Evidence

or "VSOE") and (2) it could accurately estimate how many hours it took to complete projects ("ability to estimate"). Therefore, Saba's finance personnel depended on accurate time records to ensure that Saba recognized revenue in accordance with GAAP.

10. From at least 2008 through the second quarter of Saba's fiscal 2012, Saba professional services employees and managers engaged in two time-keeping practices that led to its false revenue recognition. First, there were multiple incidents of ICG Consultants recording hours and billing customers for the performance of professional services in advance of performing those services in order to accelerate revenue recognition and achieve quarterly revenue targets ("pre-booking"). Second, ICG and Field Consultants regularly failed to report professional services time worked in order to conceal budget overruns from management and finance, instead recording that time to non-billable project codes or not at all ("under-booking").

11. These improper time-keeping practices precluded the time records from serving as reliable evidence under GAAP to recognize revenue in the manner that Saba did. As such, Saba management has concluded that Saba cannot demonstrate VSOE for the period from 2008 through the second quarter of fiscal 2012. Over that period, therefore, Saba was required to recognize professional services revenues on a completed contract basis, which would have required it to defer substantially all of its professional services revenue and much of its license revenue (where software licenses were bundled with professional services) until the contract was completed. Accordingly, virtually all of Saba's professional services revenue was misstated over the relevant time period because revenue was recognized earlier than it should have been under the applicable accounting principles.

12. The practices of pre-booking and under-booking were directed by and known to numerous individuals in the professional services organization and ICG, including the two most senior Saba employees overseeing the professional services organization in North America over the relevant time period. Those senior Saba employees were told on multiple occasions by the finance department that the Company's accountants and auditors needed to understand exactly how many hours were being worked and when (regardless of whether or not they were billed to the customer) in order to ensure that revenue was recognized accurately, and they understood that inaccurate time-keeping would lead to misstatements in Saba's reported professional services revenue and violate the Company's policies regarding financial reporting, including the Code of Business Conduct and the Revenue Recognition Policy.

B. Scope and Impact of the Fraud

13. Saba's professional services revenues, gross margins and income were materially overstated in its periodic filings from October 4, 2007 through January 6, 2012 as a result of the time-reporting misconduct.

14. The practices of pre-booking and under-booking, and the fundamental inaccuracy in Saba's time records revealed by these practices, have led Saba management to conclude that it can no longer rely on its calculation of VSOE of fair value for professional services. In this circumstance, ASC 985-605 (Certain Revenue Arrangements That Include Software Elements) and

ASC 605-35 (Revenue Recognition) require that the Company defer to the point where services are complete, rather than recognize over the period where services are performed, standalone services revenue and revenue on software license and cloud services agreements that contain bundled professional services. Accordingly, Saba has determined and announced that it is required to restate its financial statements for the years 2008, 2009, 2010 and 2011, and the first two quarters of 2012, due to its material non-compliance with GAAP. Although Saba has not yet filed its required restatement, the cumulative impact of this alternative revenue recognition treatment is approximately $70 million over the period from 2008 through the second fiscal quarter of 2012. The Company expects that the restatement will change the time period during which the affected revenues are recognized, generally shifting the timing of such revenues to later periods.

15. These misstatements are material. First, based on the Company's own estimates, the restated financials will reflect overstatements of gross revenue and profit of more than 5% in each year for the period 2008 through 2011. Second, the effect of the inflated revenue was that Saba met analyst expectations for EPS in certain quarters and caused at least one year (2010) to reflect net income when, but for the inflated revenue, the Company should have reported a net loss.

C. Saba's Required Restatement

16. On August 6, 2012, Saba announced that, following an internal accounting review, management had determined that its annual financial results for fiscal years 2011 and 2010, as well as the first and second quarters of fiscal year 2012, should be restated as a result of instances of improper time-recording that it had identified in the Company's professional services business. On November 5, 2012, Saba announced that management had determined that the Company's annual financial results for fiscal years 2009 and 2008 would also need to be restated.

D. Compensation of CFOs Slater and Williams

17. During the 12-month periods that followed the filing of the periodic reports requiring restatement, Slater and Williams received bonuses and realized profits from sales of Saba stock.

18. Slater and Williams have not reimbursed those amounts to Saba.

Violations

19. Section 304 of the Sarbanes-Oxley Act of 2002 requires the chief financial officer of any issuer required to prepare an accounting restatement due to material noncompliance with the securities laws as a result of misconduct to reimburse the issuer for (i) any bonus or incentive-based or equity-based compensation received by that person from the issuer during the 12-month periods following the false filings, and (ii) any profits realized from the sale of securities of the issuer during those 12-month periods. Section 304 does not require that a chief financial officer engage in misconduct to trigger the reimbursement requirement. Slater and Williams both realized Saba stock-sale profits and received bonuses during the 12-month periods following the filings

containing financial results that Saba is required to restate. They have not, to date, reimbursed the Company for those amounts. Slater and Williams have, therefore, violated Sarbanes-Oxley Section 304.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondents' Offers.

Accordingly, it is hereby ORDERED, pursuant to Section 21C of the Exchange Act, that:

A. Respondents Slater and Williams cease and desist from committing or causing any violations and any future violations of Section 304 of the Sarbanes-Oxley Act.

B. Respondent Slater shall, within 30 days of the entry of this Order, reimburse Saba for a total of $337,375 pursuant to Section 304(a) of SOX. Respondent shall simultaneously deliver proof of satisfying this reimbursement obligation to Erin Schneider, Division of Enforcement, Securities and Exchange Commission, 44 Montgomery Street, Suite 2800, San Francisco, California 94104.

C. Respondent Williams shall, within 30 days of the entry of this Order, reimburse Saba for a total of $141,992 pursuant to Section 304(a) of SOX. Respondent shall simultaneously deliver proof of satisfying this reimbursement obligation to Erin Schneider, Division of Enforcement, Securities and Exchange Commission, 44 Montgomery Street, Suite 2800, San Francisco, California 94104.

By the Commission.

Brent J. Fields
Secretary

PRESS RELEASE

SEC Announces Half-Million Dollar Clawback from CFOs of Silicon Valley Company That Committed Accounting Fraud

FOR IMMEDIATE RELEASE
2015-28

Washington D.C., Feb. 10, 2015 — The Securities and Exchange Commission today announced that two former CFOs have agreed to return nearly a half-million dollars in bonuses and stock sale profits they received while their Silicon Valley software company was committing accounting fraud.

According to the SEC's order instituting a settled administrative proceeding, William Slater and Peter E. Williams III received $337,375 and $141,992 respectively during time periods when Saba Software presented materially false and misleading financial statements. While not personally charged with the company's misconduct, Slater and Williams are still required under Section 304 of the Sarbanes-Oxley Act to reimburse the company for bonuses and stock sale profits received while the fraud occurred. Saba Software overstated its pre-tax earnings and made material misstatements about its revenue recognition practices while Slater served as CFO from December 2008 to October 2011 and while Williams served as CFO from October 2011 to January 2012.

"During any period when a company materially misrepresents its financial results, even executives who were not complicit in the fraud have an obligation to return their bonuses and stock sale profits to the company for the benefit of the shareholders who were misled," said Jina L. Choi, Director of the SEC's San Francisco Regional Office.

Last year, the SEC charged Saba Software and two former executives responsible for the accounting fraud in which timesheets were falsified to hit quarterly financial targets. As part of that settlement, the SEC similarly reached an agreement with the former CEO to reimburse the company $2.5 million in bonuses and stock profits that he received while the accounting fraud was occurring, even though he was not charged with misconduct.

Slater and Williams each consented to the entry of the SEC's order without admitting or denying the finding that they violated Section 304 of the Sarbanes-Oxley Act.

The SEC's investigation was conducted by Mike Foley, Rebecca Lubens, and Erin Schneider of the San Francisco Regional Office.

###

Related Materials

- SEC order

PRESS RELEASE

SEC Charges Software Company in Silicon Valley and Two Former Executives Behind Fraudulent Accounting Scheme

CEO Agrees to Return $2.5 Million Under Clawback Provision

FOR IMMEDIATE RELEASE
2014-214

Washington D.C., Sept. 24, 2014 — The Securities and Exchange Commission today charged a Silicon Valley-based software company and two former executives behind an accounting fraud in which timesheets were falsified to hit quarterly financial targets.

An SEC investigation found that company vice presidents Patrick Farrell and Sajeev Menon were atop a scheme at Saba Software in which managers based in the U.S. directed consultants in India to either falsely record time that they had not yet worked, or purposely fail to record hours worked during certain pay periods to conceal budget overruns from management and finance divisions. The improper time-reporting practices enabled Saba Software to achieve its quarterly revenue and margin targets by improperly accelerating and misstating virtually all of its professional services revenue during a four-year period as well as a substantial portion of its license revenue.

Saba Software agreed to pay $1.75 million to settle the SEC's charges, and Farrell and Menon agreed to settle the case as well.

Under the "clawback" provision of the Sarbanes-Oxley Act, executives can be compelled to return to the company and its shareholders certain money they earned while their company was misleading investors. In a separate order instituted today, the SEC required Saba Software's CEO Babak "Bobby" Yazdani to reimburse the company

$2.5 million in bonuses and stock profits that he received while the accounting fraud was occurring, even though he was not charged with misconduct.

"CEOs and CFOs can be deprived of bonuses and stock profits if there is misconduct on their watch that requires a restatement by their employer," said Andrew J. Ceresney, Director of the SEC's Division of Enforcement. "We will not hesitate to pursue clawbacks in appropriate cases."

According to the SEC's order instituting a settled administrative proceeding, Saba Software offers professional services often sold simultaneously with software products. The professional services historically have accounted for about one-third of approximately $120 million in yearly revenues, and the company maintains a group of consultants within its subsidiary in India to help deliver professional services to its customers. The SEC's order finds that Saba Software's timekeeping practices of "pre-booking" and "under-booking" hours worked by these consultants precluded the time records from serving as reliable evidence under U.S. Generally Accepted Accounting Principles to recognize revenue in the manner that the company did. Therefore, from Oct. 4, 2007 to Jan. 6, 2012, Saba Software cumulatively overstated its pre-tax earnings by approximately $70 million.

According to the SEC's order, Farrell and Menon were responsible for ensuring that the professional services group within Saba Software met financial targets set by senior management. Farrell was aware of situations where consultants planned to pre-book hours in order to achieve their quarterly revenue targets yet he failed to stop the practice. In other instances when they had overrun their budgets, he directed consultants to "eat" the hours or back them out of the timesheet database. Menon directed consultants reporting to him to book time to the timesheet database at quarter-end even though those hours would not be worked until the following quarter. In other instances, he advised them to avoid inputting in the timekeeping system non-billable hours that they had worked.

The SEC's order further finds that internal accounting controls at Saba Software were ineffective to counter-balance the revenue and margin targets set by senior management. This problem was particularly acute in Saba Software's India-based consulting group, which was referred to throughout the consulting organization as a "black box." This characterization reflected the fact that U.S. and European managers approving time records of India-based consultants for revenue recognition purposes had little visibility into who was performing what work and when.

"Saba Software used off-shore operations to cut costs, but also cut corners on its internal controls over financial reporting," said Jina L. Choi, Director of the SEC's San Francisco Regional Office. "Weak internal controls create greater opportunity for accounting fraud, and investors are left holding the bag."

Saba Software consented to the entry of an order finding that it violated the anti-fraud, books and records, and internal control provisions of the federal securities laws. In addition to the $1.75 million financial penalty, Saba Software agreed to pay further penalties if it has not filed restatements of its earnings during those periods by later this year, and revocation of the registration for its securities if it doesn't file those restatements by early next year. Without admitting or denying the findings in the order, Saba Software also agreed to cease and desist from committing or causing future violations of these provisions of the securities laws.

Farrell and Menon each consented to the entry of an order finding that they violated the anti-fraud provisions and caused Saba Software's violations. The order also finds that they falsified books and records and circumvented the company's internal controls. Farrell agreed to pay disgorgement and prejudgment interest of $35,017 and a penalty of $50,000, and Menon agreed to pay disgorgement and prejudgment interest of $19,621 and a penalty of $50,000. Without admitting or denying the findings, they each agreed to cease and desist from committing or causing future violations of these provisions the securities laws.

Yazdani consented to reimburse Saba Software for $2,570,596 in bonuses, incentive compensation, and stock sale profits that he received following the regulatory filings that the company is now required to restate. He neither admitted nor denied the findings against the company in the order.

The SEC's investigation, which is continuing, is being conducted by Mike Foley, Rebecca Lubens, and Erin Schneider of the San Francisco Regional Office.

###

Related Materials

- SEC order: Saba Software, Farrell, and Menon
- SEC order: Yazdani

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73201 / September 24, 2014

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3584 / September 24, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16160

In the Matter of **BABAK ("BOBBY") YAZDANI** **Respondent.**	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Bobby Yazdani ("Respondent").

II.

In anticipation of the institution of these proceedings, the Respondent has submitted an Offer of Settlement (the "Offer") that the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over each and over the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that:

Summary

1. This matter involves misstated revenues in the professional services organization at Saba Software, Inc. ("Saba" or "the Company"), a Silicon Valley-based enterprise software company. The misstatements were the result of the falsification of time records over a period of more than four years by professional services managers in multiple geographies directing consultants in Saba's Indian subsidiary (the India Consulting Group or "ICG") to falsify time records by either recording time in advance of performance of work or failing to record time for hours worked in order to achieve their quarterly revenue and margin targets.

2. As a result, Saba reported false financial results in its financial statements filed with the Commission over the period from October 4, 2007 through January 6, 2012. As Saba announced on August 6, 2012 and November 5, 2012, management has determined that the Company is required to restate its financial statements for fiscal years 2008 through 2011, as well as the first two quarters of fiscal 2012. The Company expects that the restatement will change the time period during which the affected revenues are recognized, generally shifting the timing of such revenues to later periods.

3. Saba's Chief Executive Officer, Bobby Yazdani, received bonuses and incentive- and equity-based compensation from Saba, and also realized Saba stock-sale profits, during the 12-month periods following the filings containing financial results that Saba is required to restate. Yazdani has not, to date, reimbursed Saba for those amounts.

Respondent and Related Entity

4. **Bobby Yazdani**, age 49, has a primary residence in Potomac, Maryland and a condominium in Redwood Shores, California. He founded Saba in April 1997 and served as CEO from then until 2002 and again from 2003 to March 2013. He served as Chairman of the Board from April 1997 until March 2013. He resigned both positions in March 2013. Yazdani is currently self-employed.

5. **Saba Software, Inc.** ("Saba" or "the Company") is a Delaware corporation headquartered in Redwood Shores, California. The software company provides cloud-based enterprise learning, talent management and social networking tools to businesses and large organizations. At all relevant times, Saba's common stock has been registered pursuant to Section

[1] The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

12 of the Exchange Act. From its IPO in April 2000 until July 31, 2006, its common stock was registered pursuant to Section 12(g). Thereafter, until June 2013, it was registered pursuant to Section 12(b). It traded on the Nasdaq Global Market until it was suspended on April 9, 2013, and then it was delisted effective June 17, 2013 for failure to remain compliant with its SEC reporting obligations. Upon its delisting and deregistration from Section 12(b), it reverted to its previous Section 12(g) registration. Its common stock is currently registered pursuant to Section 12(g) and traded on the OTC Markets. Saba has not filed any periodic reports since January 6, 2012, when it filed its Form 10-Q for the quarter ended November 30, 2011.

Facts

A. Saba's Falsification of Time Records

6. Saba's professional services historically has accounted for about one third of its approximately $120 million in yearly revenues. Professional services have been delivered to customers worldwide by (1) customer-facing field consultants in North America and Europe ("Field Consultants") and (2) off-shore technical development services provided to the Field Consultants by the Company's India Consulting Group ("ICG Consultants"). ICG is an organization within Saba's Indian subsidiary designed to help the Company deliver professional services to its customers at a lower cost than comparable consultants in North America and Europe. By 2011, ICG employed 50-60 consultants who generated approximately 14,000 hours of billable work per quarter, which constituted about 17% of consulting revenue and 6% of total revenue per quarter.

7. Both Field Consultants and ICG Consultants were required to record time worked on customer projects in a timesheet database. Hours input into the system by Field or ICG Consultants were approved on a weekly basis by project managers in North America and Europe, and revenue for the professional services organization was then measured based on the approved number of hours in the timesheet database.

8. Saba disclosed in its public filings that it recognized revenue for both "time and materials" and "fixed fee" contracts as the services were performed. This revenue recognition treatment was consistent with GAAP only if Saba could demonstrate that (1) its customers have historically paid a consistent rate for its services (measured by Vendor Specific Objective Evidence or "VSOE") and (2) it could accurately estimate how many hours it took to complete projects ("ability to estimate"). Therefore, Saba's finance personnel depended on accurate time records to ensure that Saba recognized revenue in accordance with GAAP.

9. From at least 2008 through the second quarter of Saba's fiscal 2012, Saba professional services employees and managers engaged in two time-keeping practices that led to its false revenue recognition. First, there were multiple incidents of ICG Consultants recording hours and billing customers for the performance of professional services in advance of performing those services in order to accelerate revenue recognition and achieve quarterly revenue targets ("pre-booking"). Second, ICG and Field Consultants regularly failed to report professional services time

worked in order to conceal budget overruns from management and finance, instead recording that time to non-billable project codes or not at all ("under-booking").

10. These improper time-keeping practices precluded the time records from serving as reliable evidence under GAAP to recognize revenue in the manner that Saba did. As such, Saba management has concluded that Saba cannot demonstrate VSOE for the period from 2008 through the second quarter of fiscal 2012. Over that period, therefore, Saba was required to recognize professional services revenues on a completed contract basis, which would have required it to defer substantially all of its professional services revenue and much of its license revenue (where software licenses were bundled with professional services) until the contract was completed. Accordingly, virtually all of Saba's professional services revenue was misstated over the relevant time period because revenue was recognized earlier than it should have been under the applicable accounting principles.

11. The practices of pre-booking and under-booking were directed by and known to numerous individuals in the professional services organization and ICG, including the two most senior Saba employees overseeing the professional services organization in North America over the relevant time period. Those senior Saba employees were told on multiple occasions by the finance department that the Company's accountants and auditors needed to understand exactly how many hours were being worked and when (regardless of whether or not they were billed to the customer) in order to ensure that revenue was recognized accurately, and they understood that inaccurate time-keeping would lead to misstatements in Saba's reported professional services revenue and violate the Company's policies regarding financial reporting, including the Code of Business Conduct and the Revenue Recognition Policy.

B. Scope and Impact of the Fraud

12. Saba's professional services revenues, gross margins and income were materially overstated in its periodic filings from October 4, 2007 through January 6, 2012 as a result of the time-reporting misconduct.

13. The practices of pre-booking and under-booking, and the fundamental inaccuracy in Saba's time records revealed by these practices, have led Saba management to conclude that it can no longer rely on its calculation of VSOE of fair value for professional services. In this circumstance, ASC 985-605 (Certain Revenue Arrangements That Include Software Elements) and ASC 605-35 (Revenue Recognition) require that the Company defer to the point where services are complete, rather than recognize over the period where services are performed, standalone services revenue and revenue on software license and cloud services agreements that contain bundled professional services. Accordingly, Saba has determined and announced that it is required to restate its financial statements for the years 2008, 2009, 2010 and 2011, and the first two quarters of 2012, due to its material non-compliance with GAAP. Although Saba has not yet filed its required restatement, the cumulative impact of this alternative revenue recognition treatment is approximately $70 million over the period from 2008 through the second fiscal quarter of 2012. The Company expects that the restatement will change the time period during which the affected revenues are recognized, generally shifting the timing of such revenues to later periods.

14. These misstatements are material. First, based on the Company's own estimates, the restated financials will reflect overstatements of gross revenue and profit of more than 5% in each year for the period 2008 through 2011. Second, the effect of the inflated revenue was that Saba met analyst expectations for EPS in certain quarters and reversed at least one year (2010) from a net income to a net loss for the year.

C. Saba's Required Restatement

15. On August 6, 2012, Saba announced that, following an internal accounting review, management had determined that its annual financial results for fiscal years 2011 and 2010, as well as the first and second quarters of fiscal year 2012, should be restated as a result of instances of improper time-recording that it had identified in the Company's professional services business. On November 5, 2012, Saba announced that management had determined that the Company's annual financial results for fiscal years 2009 and 2008 would also need to be restated.

D. Compensation of CEO Yazdani

16. During the 12-month periods that followed the filing of the periodic reports requiring restatement, Yazdani received cash incentive awards and bonuses and also realized profits from sales of Saba stock.

17. Yazdani has not reimbursed those amounts to Saba.

Violations

18. Section 304 of the Sarbanes-Oxley Act of 2002 requires the chief executive officer of any issuer required to prepare an accounting restatement due to material noncompliance with the securities laws as a result of misconduct to reimburse the issuer for (i) any bonus or incentive-based or equity-based compensation received by that person from the issuer during the 12-month periods following the false filings, and (ii) any profits realized from the sale of securities of the issuer during those 12-month periods. Section 304 does not require that a chief executive officer engage in misconduct to trigger the reimbursement requirement. Yazdani received bonuses and incentive- and equity-based compensation from Saba, and also realized Saba stock-sale profits, during the 12-month periods following the filings containing financial results that Saba is required to restate. He has not, to date, reimbursed the Company for those amounts.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent's Offer.

Accordingly, it is hereby ORDERED, pursuant to Section 21C of the Exchange Act, that**:**

A. Respondent Yazdani cease and desist from committing or causing any violations and any future violations of Section 304 of the Sarbanes-Oxley Act.

B. Respondent Yazdani shall, within 30 days of the entry of this Order, reimburse Saba for a total of $2,570,596 in Saba bonuses, other incentive-based or equity-based Saba compensation, and Saba stock sale profits pursuant to Section 304(a) of SOX. Respondent shall simultaneously deliver proof of satisfying this reimbursement obligation to Erin Schneider, Division of Enforcement, Securities and Exchange Commission, 44 Montgomery Street, Suite 2800, San Francisco, California 94104.

By the Commission.

Brent J. Fields
Secretary

750 E. PRATT STREET SUITE 900 BALTIMORE, MD 21202
T 410.244.7400 F 410.244.7742 www.Venable.com

March 17, 2015

Exclusive Forum Bylaws – New Research Shows Favorable Impact

In recent years, public companies have increasingly become targets of internal affairs litigation over the same corporate action in multiple jurisdictions. Multi-forum litigation can create significant problems, including unnecessarily redundant, inconvenient, costly and time-consuming lawsuits and inconsistent judicial decisions, requiring still further proceedings to resolve. As succinctly explained by Vice Chancellor Laster of the Delaware Court of Chancery in a recent multi-forum action: "This case really exemplifies the interforum dynamics that have allowed plaintiff's counsel to extract settlements in M&A litigation and that have generated truly absurdly high rates of litigation challenging transactions."[1] Indeed, we have seen Maryland-formed companies subjected to litigation in Maryland and simultaneously in states as far away as California and Arizona arising out of the same corporate actions. As a result, corporations and real estate investment trusts formed in Maryland, Delaware and other jurisdictions have adopted exclusive forum bylaw provisions requiring certain intracorporate disputes to be brought in the courts of the state of incorporation. Over the last few years, Delaware courts have repeatedly addressed the legitimacy and scope of these provisions and, as discussed below, a proposed amendment to the Delaware General Corporation Law (the "DGCL") that would codify the right to adopt an exclusive forum provision is currently under consideration in Delaware.

Now, an important new study demonstrates the beneficial impact of exclusive forum bylaws on reducing multi-forum litigation in large M&A transactions. According to a report by Cornerstone Research released just last month, shareholder lawsuits were filed in 93% of public company M&A transactions valued at over $100 million in 2014, with an average of more than four lawsuits filed per transaction – an increase from 54% in 2008. However, in 2014, only 40% of these transactions were challenged in more than one jurisdiction, and only four percent were challenged in more than two jurisdictions (the lowest number since 2007). This is a dramatic decrease from 2013, when 62% of these transactions were challenged in more than one jurisdiction and an average of over five lawsuits were filed per transaction. The author specifically states that this decline in multi-forum litigation is "likely a result of widespread adoption of forum selection clauses in corporate bylaws."[2]

[1] *Edgen Group Inc. v. Genoud*, No. 9055-VCL (Del. Ch. Nov. 5, 2013). *See also* LEO E. STRINE, JR., LAWRENCE A. HAMERMESH & MATTHEW C. JENNEJOHN, *Putting Stockholders First, Not the First-Filed Complaint*, 69 BUS. LAW. 1, 8 (2013) ("In recent years, shareholder class actions challenging mergers and acquisitions have become more prevalent, and so have instances in which litigation of this sort has been brought more or less concurrently in multiple forums."). Internal affairs litigation is also common in contexts other than just M&A transactions.
[2] Olga Koumrian, *Shareholder Litigation Involving Acquisitions of Public Companies*, CORNERSTONE RESEARCH (February 2015).

Development under Delaware Law

The scope and enforceability of exclusive forum bylaw provisions have developed through several Delaware cases in the last few years. The seminal opinion was issued on June 25, 2013 in two consolidated cases, *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, Del. Ch. C.A. No. 7220-CS, and *IClub Investment Partnership v. FedEx Corp.*, Del Ch. C.A. No. 7238-CS (together "*Chevron*"). In *Chevron*, Chancellor Strine of the Delaware Court of Chancery (now Chief Justice of the Delaware Supreme Court) held that, with regard to a facial challenge to exclusive forum bylaw provisions enacted by Chevron and FedEx, (1) the venue for stockholder corporate and derivative litigation was a proper subject for regulation by bylaw, (2) exclusive forum bylaw provisions unilaterally adopted by directors are "valid and enforceable" as to stockholders and (3) hypothetical situations in which a particular bylaw *could* prove unreasonable did not make it facially invalid. While the court noted that exclusive forum bylaw provisions are always subject to as-applied challenges, *i.e.*, a board's adoption of the provision is still subject to scrutiny in the context of particular facts and circumstances, Chancellor Strine stated that "[s]uch circumstantial challenges are required to be made based on real-world circumstances by real parties, and are not a proper basis for the survival of the plaintiffs' claims that the bylaws are facially invalid under the DGCL."

As a result of *Chevron*, over 600 public corporations and real estate investment trusts, including over 60 Maryland public companies, have adopted exclusive forum provisions. Indeed, these provisions have become mainstream since the *Chevron* decision.

Following *Chevron*, Chancellor Bouchard in *City of Providence v. First Citizens Bancshares, Inc.*,[3] held that Chancellor Strine's analysis in *Chevron* would apply to exclusive forum bylaw provisions dictating a forum other than the state of incorporation. The bylaw in question was, according to the court "[i]n all but two respects . . . functionally identical to the bylaws . . . challenged in *Chevron*." The two differences concerned (a) language stating that the bylaw is applicable only "to the fullest extent permitted by law" (a difference which was not addressed) and (b) designating North Carolina, the state where the company was headquartered, as the exclusive forum for litigation, rather than Delaware (the state of incorporation).

The *Providence* court upheld the exclusive forum bylaw provision in question, stating that "nothing in the text or reasoning of *Chevron* can be said to prohibit directors of a Delaware corporation from designating an exclusive forum other than Delaware in its bylaws." Further, the court added that the company's decision to designate North Carolina, the "second most obviously reasonable forum given that [the company] is headquartered and has most of its operations there . . . does not . . . call into question the facial validity of the Forum Selection Bylaw." The court went on to hold that it did "not discern an overarching public policy of [Delaware] that prevents boards of directors of Delaware corporations from adopting bylaws [requiring] stockholders to litigate intra-corporate disputes in a foreign jurisdiction."

[3] C.A. No. 9795-CB (Del Ch. Sept. 8, 2014).

VENABLE LLP

Plaintiffs in *Providence* also challenged the timing of the adoption of the exclusive forum bylaw provision at issue. In *Providence*, the board of directors of First Citizens Bancshares, Inc. approved the exclusive forum bylaw provision at the same meeting the board approved a merger with First Citizens Bancorporation, Inc. In addition to the challenges discussed above, the plaintiffs claimed that enforcing the bylaw would be "unjust" and "goes well beyond [plaintiffs'] reasonable expectations" given the timing of adoption. The court disagreed and stated: "That the Board adopted [the exclusive forum bylaw] on an allegedly 'cloudy' day when it entered into the merger agreement . . . rather than on a 'clear' day is immaterial given the lack of any well-pled allegations . . . demonstrating any impropriety in this timing."

Finally, the Delaware Supreme Court, in an opinion by Chief Justice Strine, has recently reaffirmed the validity of board-adopted exclusive forum bylaw provisions.[4]

<u>*Enforceability under Maryland Law*</u>

Although there is no controlling Maryland case on point, the Court of Appeals of Maryland (our highest state court), the Court of Special Appeals (our intermediate appellate court) and our trial courts, as well as other courts interpreting Maryland law, "have historically found Delaware law in matters involving business law highly persuasive."[5] Thus, we think that *Chevron* and its progeny provide strong authority supporting the validity and enforceability of an exclusive forum bylaw provision in Maryland.

<u>*Delaware Statutory Developments*</u>

Earlier this month, the Corporation Law Council of the Delaware State Bar Association announced its proposed amendments to the DGCL for 2015, which include a new Section 115 that would, if adopted, codify a corporation's right to include an exclusive forum provision in its certificate of incorporation or bylaws. Any exclusive forum provision would apply only to "intracorporate claims," as defined in the proposed amendment. Further, Delaware corporations would be required to specify Delaware as the exclusive forum for any intracorporate claims, thus overruling *Providence* in part and disallowing a forum other than the state of incorporation. The full text of the proposed amendment to the DGCL is attached hereto as <u>Exhibit A</u>.

* * * *

As always, we and our colleagues are available at any time to discuss these or other matters of Maryland law.

Jim Hanks
Dan Mendelsohn

---

[4] *See United Tech. Corp. v. Treppel*, No. 127, 2014 (Del. Dec. 23, 2014) (*en banc*).
[5] *In re Nationwide Health Properties, Inc. Shareholder Litigation*, No. 24-C-11-001476, slip op. at 16 (Md. Cir. Ct. May 27, 2011) (opinion of Berger, J., now a judge of the Court of Special Appeals of Maryland).

This memorandum is not intended to provide legal advice or opinion. Such advice may only be given when related to specific fact situations for which Venable LLP has accepted an engagement as counsel.

EXHIBIT A

PROPOSED AMENDMENT TO THE DGCL

§ 115. Forum selection provisions.

The certificate of incorporation or the bylaws may require, consistent with applicable jurisdictional requirements, that any or all intracorporate claims shall be brought solely and exclusively in any or all of the courts in this State, and no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this State. "Intracorporate claims" means claims, including claims in the right of the corporation, (i) that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity, or (ii) as to which this title confers jurisdiction upon the Court of Chancery.