



SEC Update

March 15, 2016

See note below about Hogan Lovells

SEC staff issues no-action letter facilitating Rule 144 sales of REIT shares received in exchange for operating partnership units

On March 14, the staff of the SEC's Division of Corporation Finance issued a no-action letter that will enable holders of shares of a publicly traded real estate investment trust (REIT) received in exchange for privately placed units of the REIT's operating partnership to sell the shares under Rule 144 without having to start a new holding period for them. The staff issued the letter in response to a no-action request jointly submitted by Bank of America, N.A. and Merrill Lynch, Pierce, Fenner & Smith Incorporated and three law firms, including Hogan Lovells. The letter is captioned *Bank of America, N.A., Merrill Lynch, Pierce, Fenner & Smith Incorporated* and is available [here](#).

The parties submitting the no-action request did not identify specific parties or specific transactions to which the SEC staff directed its no-action relief. The staff's no-action letter accordingly represents an interpretive position on which any holder of REIT shares received in a covered exchange transaction should be able to rely. By facilitating Rule 144 resales, the no-action relief could reduce the number of registration statements REITs have to file related to these exchange transactions, alleviate the hardships that would be encountered by unit holders in the event a registration statement is not available, and provide lenders greater comfort in accepting units as collateral for loans.

Background

Entity and transaction structure. The staff's no-action relief encompasses exchange transactions involving securities of entities in an umbrella partnership real estate investment trust (UPREIT) structure as summarized in the no-action request.

REIT and operating partnership. In an UPREIT structure, all of the REIT's real estate assets are acquired and owned directly or indirectly by its umbrella partnership, which is organized as a limited partnership or limited liability company and is typically referred to as an "operating partnership." The REIT's only material assets are its holdings of interests (units) in the operating partnership, through which the REIT operates its business. The REIT either serves as the general partner of the operating partnership or controls the general partner.

Operating partnership units. Units also are held by other investors that



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acquire the securities in non-public offerings, typically in exchange for real estate assets they contributed to the operating partnership, either at the time of the REIT's initial public offering or in subsequent transactions. These investors pay the full purchase price for their units when they acquire them. There is no public market for the units, which are subject to significant transfer restrictions under the agreement governing the formation of the operating partnership.

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One unit is the economic equivalent of one share of common stock of the REIT, or of another specified number of shares of REIT common stock fixed to ensure economic parity between the REIT shares and the units. The units are substantially identical economically to the REIT shares, in that they represent the same right to the same proportionate interest in the same underlying pool of assets.

Exchange transaction. The REIT shares are registered under Section 12 of the Exchange Act and are publicly traded on a national securities exchange. After an initial one-year holding period, unit holders may request that the operating partnership redeem their units for cash. The REIT, at its option, may assume the operating partnership's redemption obligation and acquire the units for REIT shares based on the fixed ratio. Unit holders are not required to pay any additional consideration for the REIT shares at redemption, and the cash value of each unit at redemption directly corresponds to the REIT common stock's market value at that time.

Rule 144. Rule 144 provides a "safe harbor" from registration under the Securities Act for sales by holders of "restricted securities," which are securities acquired from the issuer or an affiliate of the issuer in a transaction not involving a public offering. Under Rule 144(d)'s "holding period" requirement, the securities must be held for at least six months after they have been fully paid for (or for at least one year if the securities are issued by a company that has been public for fewer than 90 days). In some situations, a holder of restricted securities may "tack" (or add on) the holding period of other parties or related securities to the holding period of newly acquired securities.

Before it issued the no-action letter, the SEC staff had not formally addressed the application of the holding period requirement to REIT shares received in exchange for operating partnership units, although it informally had indicated that a new holding period was required for the shares. Under this position, a unit holder's Rule 144(d) holding period for the REIT shares began upon its acquisition of the shares rather than upon its acquisition of the units it exchanged for the shares.

The staff's informal view had the unfortunate effect of subjecting holders of units who privately exchanged their units for REIT shares to a waiting period under Rule 144 of at least six months after receipt of the shares before they could sell the shares publicly. This would be a hardship for the holders, because, although taxes on the exchange would be triggered when the exchange occurred, the holders could not sell their shares under Rule 144 to help pay for the taxes until at least six months had elapsed. Many REITs have addressed the hardship by filing a registration statement under the Securities Act covering either the exchange of the units for REIT shares or the resale of the REIT shares received upon exchange. These filings require considerable time and expense to complete.

No-action request

The parties requesting no-action relief asked the SEC staff to concur with their view that a seller of REIT shares received upon an exchange of operating partnership units should be allowed under Rule 144 to tack the holding period of the units to the holding period of the REIT shares and therefore be able to sell the REIT shares immediately upon receipt if the units had been held for the requisite period. The staff traditionally has taken the position that the holding period requirement is satisfied only if the seller has been at full economic risk with respect to the securities for the entire period required by Rule 144. Where an exchange of securities occurs, the economic risk of the new securities typically is different from that of the exchanged securities, thereby requiring the start of a new holding period.

The requestors argued in their submission that in the case of a REIT structured as an UPREIT, the economic risk of the operating partnership units is identical to that of the REIT shares (apart from tax considerations). Under the UPREIT structure, the operating partnership units and the REIT common stock acquired upon redemption represent the same proportionate right to the assets of the operating partnership, so that the exchange does not result in any change to the economic risk of the investment in the underlying assets. The

unit holder has the same economic risk as a holder of REIT common stock during the entire period it holds the units and the unit holder retains the same economic risk and the same proportionate share of the underlying real estate assets after the exchange. Accordingly, from the date the unit holder pays the full purchase price for the units to the date it exchanges the units for REIT common stock, the economic value of a unit is the same as the market price of, and therefore the economic value of, a corresponding share of REIT common stock. Because the economic risk is the same after the exchange, the requestors said the holding periods of the two securities should be combined under the rule.

The staff agreed with the requestors that the holding periods of operating partnership units and REIT shares could be tacked under Rule 144. Because most UPREITs are structured to require holders of units to hold their units for at least one year, the staff's position will permit most unit holders to sell immediately under Rule 144 any REIT shares they receive in exchange for the units. Sales by affiliates of the REIT will be subject to the volume limitation and other requirements of Rule 144. For tax purposes, a new holding period will commence upon that exchange, so a sale within one year after the exchange would result in short-term capital gain to the extent the shares have appreciated in value since the exchange.

The staff's position is consistent with two orders the SEC issued in 1995 and 1998 under Section 12(h) of the Exchange Act that exempted two REITs having an UPREIT structure from the application of Section 16 of that Act to their ownership of, and transactions in, units of their operating partnerships. The orders, the first of which was obtained upon a request prepared by our firm, were based on the same principle on which the request for the new no-action letter was based, which is that the economic risk is the same (apart from taxes) for both the operating partnership units and the REIT shares received in exchange for them, so that no purchase or sale effectively occurs under Section 16 upon the exchange.

This SEC Update is a summary for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. If you have any questions or would like any additional information regarding this matter, please contact your relationship partner at Hogan Lovells or any of the lawyers listed on the right hand side of this update.

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