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Real Estate Securities and the Foreign Investor—Some Problems and a Proposal

Marc H. Morgenstern*

This article looks at some of the securities law issues that arise when real estate development financing is provided by foreign partners. The article notes that while there is heavy reliance on the foreign offering exemption to avoid having to register securities, there are no clear markings as to what the parameters of the exemption should be. To remedy this situation, the author contends that the SEC should adopt a rule describing the exemption rather than rely solely on the administrative discretion of the Commission's staff. The author also provides a proposed rule which the SEC can use to help shape its own proposal.

Introduction

United States developers have increasingly sought financing of U.S. real estate projects (domestic real estate) from non-United States partners or lenders. Such an investment is attractive to nonresident aliens (foreign investors) for several reasons.[1] First, such an investment represents an inflation hedge.

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* Principal, Kahn, Kleinman, Yanowitz & Arnson Co., L.P.A., Cleveland, Ohio. The author thanks James J. Bartolozzi, Gerald S. Niesar, Peter L. Rubin, and Robert J. Valerian for their helpful comments and Judith Kopetchne for her help in preparing the bibliography for this article.

[1] See also Berger, "Foreign Investment in U.S. Real Estate: Scope and Policy Issues," Real Est. Issues, Summer 1977; Heideman, "Pursuing the Foreign Investor," 10 Real Est. Rev. 44 (1980); Note, "Foreign Investment in United States Real Estate: Federal and State Regulation," 12 Case W. Res. J. Int'l L. 231, 233 (1980). See generally Secretary of Commerce, U.S. Dep't of Commerce, *Report to the Congress, Foreign Investment in the United States* 98 (vol. 1, April 1976).

Second, in contrast to many countries, the United States is a political and economic haven—comparatively free of fear of political instability or economic nationalization. Third, investment in domestic real estate, to be repaid in United States currency, offers protection to foreign investors concerned that their home currency will be devalued.[2] Lastly, it provides an opportunity for risk diversification for sophisticated foreign investors who diversify the nature and geopolitical location of their capital investments.

When foreign investors directly purchase and hold an undivided interest in domestic real estate, no securities laws issues are raised. When real estate is owned indirectly, however, in the form of partnership or joint venture interests, such transnational financing provokes difficult questions regarding the applicability of federal[3] and state[4] securities laws to the sale of such interests.

This article analyzes when real estate interests are securities subject to the registration[5] requirements of the federal securities

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This article is concerned with indirect ownership of real property. There are numerous rules, regulations, and restrictions at the federal and state levels dealing with direct ownership of real property by foreign investors. Foreign investors in U.S. real estate must also contend with disclosure of ownership and special tax considerations applicable only to nonresident aliens. For analysis of the former, see Trooboff & Falender, *Foreign Investment in U.S. Real Property-Federal Reporting Requirements, Foreign Inv. in the U.S.* 537 (1980). For analysis of the latter, see Mihaly, "Tax Treatment of Gains Realized by Foreigners on Sale of U.S. Real Property," 16 Int'l Law. 95 (1982); Moses, "Taxation of Foreign Investors on Their Capital Gains From the Sale of United States Real Estate," 16 Int'l Law. 561 (1982); Newton, "Tax Planning: Foreign Investment in United States Real Property, 12 Ga. J. Int'l & Comp. L. 1 (1982).

[2] Devaluation is a two-edged sword. When the U.S. dollar is strong against foreign currencies, foreign investors may be reluctant to exchange their home currency into dollars for investment. When the profits are generated in U.S. currency, a change weakening the exchange ratio against the U.S. dollar may result in profits expressed in terms of U.S. dollars, but an overall loss to the investors who effect an unfavorable currency exchange.

[3] As used herein, the federal securities laws mean the Securities Act of 1933, as amended (the Securities Act), 15 U.S.C. §§ 77a, et seq. and the Securities Exchange Act of 1934, as amended (the Exchange Act), 15 U.S.C. §§ 78a, et seq.

[4] In addition to complying with federal securities laws, sales of securities to foreign investors must also satisfy applicable state blue sky provisions, if any.

[5] This article concerns only the registration issues involved in the United States. Issuers in international real estate securities transactions must also

laws. In accordance with the administrative position adopted by the Securities and Exchange Commission (SEC), an offering to foreign investors is exempt from the registration requirements, but not necessarily the antifraud provisions,[6] of the federal securities laws. The mechanics of complying with this exemption are detailed herein. Because the exemption is administrative rather than legislative in nature, the exact parameters of the exemption

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comply with the securities and currency restriction laws, if any, of the foreign investor's home country, or other countries possessing subject matter jurisdiction over the transaction.

Divergent approaches to securities regulation have been adopted throughout the world. On the one extreme, Japan's securities regulation system is modeled directly upon the Securities Act and the Securities Exchange Act. Misawa, "Securities Regulation in Japan," 6 Vand. J. Transnat'l L. 447, 477 (1973). Other countries, like Switzerland, to the extent that a system exists at all, have systems based on self-regulation. Dagon, "Securities Regulation in Switzerland," 6 Vand. J. Transnat'l L. 511 (1973). In most European countries, securities regulation is an integral part of corporation law. Jackson, "Public Offerings: A Comparative Study of Disclosure in Western Europe and the United States," 16 Wes. Res. L. Rev. 44 (1964). For a sampling of the numerous articles on foreign securities laws, see Brock, "Securities Regulation in Selected European Countries, 3 Vand. J. Transnat'l L. 21 (1969); Eizirik, "The Role of the State in the Regulation of the Securities Markets: The Brazilian Experience, 1 J. Comp. Corp. L. & Sec. Reg. 211 (1978); Johnson, "An Analysis of the Venezuelan Securities Legislation: Part I—The Primary Markets and Part II—The Secondary Markets, 12 Int'l Law. 171 (vol. 1), 241 (vol. 2) (1978); Knauss, "Securities Regulation in the United Kingdom: A Comparison with United States Practice," 5 Vand. J. Transnat'l L. 49 (1971); Schaafsma, "Netherlands Securities Laws," 33 Bus. Law. 101 (1977); Suckhow, "The European Prospectus," 23 Am. J. Comp. L. 50 (1975); Thorpe, "The Sale of U.S. Securities in Japan," 29 Bus. Law. 411 (1974); Project, "International Securities Project," 30 Bus. Law. 585 (1975); Note, "Disclosure Requirements in France: Problems in the Development of Effective Securities Regulation," 12 Va. J. Int'l L. 358 (1972).

[6] It is elementary that the antifraud provisions may apply to securities transactions not requiring registration. For some of the numerous articles discussing the complex issue of the extraterritorial application of the antifraud provisions of the federal securities laws, see, e.g., Hacker & Rotunda, "The Extraterritorial Regulation of Foreign Business Under the U.S. Securities Laws," 59 N.C. L. Rev. 643 (1981); Johnson, "Application of Federal Securities Laws to International Securities Transactions," 45 Alb. L. Rev. 890 (1981); Mizrack, "Recent Developments in the Extraterritorial Application of Section 10(b) of the Securities and Exchange Act of 1934," 30 Bus. Law. (1975); Sandberg, "The Extraterritorial Reach of American Economic Regulation: The Case of Securities Law," 17 Harv. Int'l L.J. 315 (1976); Comment, "Extraterritorial Effect of the Registration Requirements of the Securities Act of 1933," 24 Vill. L. Rev. 729 (1979).

are uncertain. Accordingly, the author urges the SEC to adopt a new rule codifying its administrative position with respect to the exemption, and calls for the state blue sky commissions to adopt a parallel exemption. A proposal for a new federal regulation is attached as an exhibit to this article.

Is an Interest in Real Estate a Security?

The Securities Act,[7] the Exchange Act,[8] and the Uniform Securities Act[9] define a security similarly as "any note, stock, bond . . . evidence of indebtedness, . . . investment contract, . . . or, in general, any interest or instrument commonly known as a 'security.' " Interests in real estate are normally held in general partnership, limited partnership, or joint venture form to take advantage of favorable federal income tax treatment.[10] Although neither federal nor most state[11] securities laws define an interest in a partnership, limited partnership, or joint venture as a security, such interests can be securities if they are "investment contracts"—a term defined as a security under federal and state securities laws.[12]

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[7] Securities Act § 2(1), 15 U.S.C. § 77b(1).

[8] Exchange Act § 3(a)(10), 15 U.S.C. § 78c(a)(10).

[9] Uniform Securities Act § 401(A). The Act has been adopted, in whole or in part, in thirty-six states, the District of Columbia, Puerto Rico, and Guam. Blue Sky L. Rep. (CCH) ¶ 5501.

[10] Under the provisions of Subchapter K of the Internal Revenue Code of 1954, as amended, entities that are taxable as partnerships rather than as corporations are not taxed at the entity level for federal income tax purposes. Because depreciation results in a deduction for tax purposes with no cash expense, many real estate projects distribute positive cash flow while allocating losses for federal income tax purposes, thereby maximizing return on investment.

[11] The statutes of Nebraska, California, and Rhode Island define transferable partnership interests as securities. Neb. Rev. Stat. § 8-1101(12); Cal. Corp. Code § 25102(f); R.I. Gen. Law Ann. § 7-11-1(c). Texas law includes interests in persons, which term includes partnerships, as a security. Tex. Sec. Act., Tex. Rev. Civ. Stat., art. 581-4A-4B (1974). Wisconsin specifically includes limited partnership interests as securities, Wis. Stat. Ann. § 551.02(13)(a).

[12] Securities Act § 2(1), 15 U.S.C. § 77b(1); Exchange Act § 3(a)(10), 15 U.S.C. § 78c(a)(10); Uniform Securities Act § 401(A).

For a consideration of when interests in partnerships, limited partnerships, or joint ventures constitute securities, see Long, "Partnership, Limited Partnership, and Joint Venture Interests as Securities," 37 Mo. L. Rev. 581 (1972); Morgenstern, "Real Estate Joint Venture Interests as Securities: The Implications of *Williamson v. Tucker*," 59 Wash. U. L.Q. 1231 (1982).

Defining Investment Contracts

SEC v. W.J. Howey Co.

The benchmark analysis of an "investment contract" was provided in *SEC v. W.J. Howey Co.*,[13] in which the Supreme Court held that an investment contract requires four elements: (1) an investment, (2) in a common enterprise, (3) with the expectation of profits, and (4) resulting solely from the efforts of another.[14] Based upon *Howey*, a general partnership or joint venture interest rarely constitutes an investment contract. Although such interests frequently involve investment, common enterprise, and expectation of profit, the fourth element of *Howey* is rarely satisfied. General partners or joint venturers normally anticipate making profits from *their* management participation rather than from the efforts of others.

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[13] 328 U.S. 293 (1946). The Supreme Court cases other than *Howey* that have examined the meaning of "investment contract" are Marine Bank v. Weaver, 455 U.S. 551 (1982) (neither a certificate of deposit nor a profit-sharing agreement were securities within the meaning of the Exchange Act); International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979) (noncontributory pension plan was not a security under the federal securities acts); United Hous., Inc. v. Forman, 421 U.S. 837 (1975) (stock in a nonprofit housing cooperative entitling the holder to lease an apartment was not a security under the federal securities laws because it had none of the indicia of stock); Tcherepnin v. Knight, 389 U.S. 332 (1967) (withdrawable capital shares of a savings and loan association were securities within the meaning of the Exchange Act); SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967) (flexible fund annuity contracts were securities under the Securities Act); SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959) (variable annuity contracts were securities within the meaning of the Securities Act); SEC v. Joiner Leasing Corp., 320 U.S. 344 (1943) (assignments of oil leases were securities under the federal securities laws).

For a sampling of commentary on the meaning of investment contract, see Coffey, "The Economic Realities of a "Security": Is There a More Meaningful Formula?" 18 W. Res. L. Rev. 367 (1967); Hannan & Thomas, "The Importance of Economic Reality and Risk in Defining Federal Securities," 25 Hastings L.J. 219 (1974); Comment, "The Federal Definition of a Security—An Examination of the "Investment Contract" Concept and the Propriety of a Risk Capital Analysis Under Federal Law," 12 Tex. Tech. L. Rev. 911 (1981).

[14] The Court held that "an investment contract, for purposes of the Securities Act means a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, . . ." 328 U.S. at 293.

Williamson v. Tucker

The *Howey* analysis was refined with specific reference to joint ventures by the Court of Appeals for the Fifth Circuit in *Williamson v. Tucker*.[15] The court held that an interest in a joint venture formed to hold and develop real estate is a security when the

> agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.[16]

Real Estate Is a Local Business

The first two parts of the *Williamson* test are frequently inapplicable to international real estate transactions since the parties to such commercial relationships are generally financially and legally sophisticated institutions and individuals. As a consequence, their contractual agreements, on the face, reserve substantial decision-making power to the foreign investor, and the investor has the capacity to exercise such powers.

Many partnership or joint ventures, however, may involve securities because of the third element of the *Williamson* test. Real estate is a peculiarly local business, sensitive to changing

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[15] 645 F.2d 404 (5th Cir.), *cert. denied*, 102 S. Ct. 396 (1981). The Fifth Circuit's decision is becoming the standard for investment contract analysis for joint ventures and general partnerships. Morrison v. Pelican Landing Dev., [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,863 (N.D. Ill. 1982) (where general partner in real estate joint venture was financially inexperienced and incapable of exercising management power, then his interest was a security); Gordon v. Terry, 684 F.2d 736 (11th Cir. 1982) (if investor can establish that his dependence on the promoter rendered him incapable of exercising his powers granted in the agreement, his interests in four trusts and one limited partnership agreement were securities).

[16] Williamson v. Tucker, 645 F.2d at 424.

economic and social conditions occurring within the immediate vicinity of the property. Decisions regarding development, construction, rental rates, lease terms, and other critical factors are based upon an intimate acquaintance with local trends, patterns, and practices. Decisions must be made and effected quickly to have maximum impact. A foreign partner or venturer would find it difficult to actively participate in such management decisions. Because the U.S. partner is more intimately acquainted with the property, and to avoid costly delays, decision-making power tends to rest with the domestic partner.

As the distance between investor and investment increases, the probability that the investor will exercise his management rights decreases. If the real estate promoter anticipates passive management from the foreign investor so that profits result from the efforts of the U.S. developer, the foreign partner's management dependence satisfies the *Howey* and *Williamson* tests and his interest is a security.

In contrast to the difficult factual analysis required to determine whether a general partnership or joint venture interest is a security, limited partnership interests are typically found to be securities. The general partner of a limited partnership formed in compliance with the Uniform Limited Partnership Act[17] or the Revised Uniform Limited Partnership Act[18] possesses total management control.[19] Limited partners necessarily anticipate making profits based on the general partner's efforts, thereby satisfying the passive investment requirement of *Howey* and *Williamson*.

With few, if any, exceptions, the sale of limited partnership interests to foreign investors involves the sale of a security. Developers who form general partnerships or joint ventures with foreign investors bear a significant risk that the foreign investor's interest is a security because of the potentially passive manage-

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[17] The Uniform Limited Partnership Act, with modifications, has been adopted in all states except Louisiana. Mann, "Investors Need the Revised ULPA," 11 Real Est. Rev. 93 (No. 2 1980).

[18] The Revised Uniform Limited Partnership Act, with modifications, has been adopted in seventeen states, 6 U.L.A. (Supp. 1983).

[19] Uniform Limited Partnership Act § 9; Revised Uniform Limited Partnership Act § 403.

ment role of the foreign investor. As a consequence, international real estate transactions must be carefully analyzed to comply with the securities laws.

Federal Registration of a Security

When any security is offered or sold, it must be registered with the SEC in accordance with the provisions of Section 5[20] of the Securities Act or qualify for an exemption from registration. Section 5 provides that it is unlawful to use the means of interstate commerce to offer or sell a security unless a registration statement is in effect with respect to such security. Because registration is expensive[21] and time-consuming, issuers attempt to avoid registration whenever possible by relying upon established exemptions.

Intrastate Exemption

An important exemption from registration is provided by Section 3(a)(11)[22] of the Securities Act and Rule 147[23] promulgated thereunder. The intrastate exemption is available when the issuer and the persons to whom the securities are sold are from a single state.[24] Traditionally, SEC interpretation has been that the intrastate exemption was not available if the offering also included foreign investors.[25] This position was in accord with

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[20] 15 U.S.C. § 77e.

[21] "Aggregate expenses for a first public offering . . . are typically in the $175,000 to $225,000 range." M. Halloran, *Going Public* 28-29 (3d ed. 1979).

[22] 15 U.S.C. § 77c(a)(11) (1976).

[23] 17 C.F.R. § 230.147 (1981).

[24] The statute provides that the registration provisions do not apply to a class of securities when the security "is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident, and doing business within, or if a corporation, incorporated by and doing business within, such State or Territory." 15 U.S.C. § 77c(a)(11) (1976).

[25] SEC No-Action Letter, Union Nat'l Bank of Laredo (Jan. 19, 1981). (Where a bank proposed to sell its shares solely to residents of the state of Texas and the country of Mexico, the offering would not be confined only to persons resident within a single state; and therefore, neither the exemption provided by § 3(a)(11) of the 1933 Act nor Rule 147 would be available.) To the same effect, see SEC No-Action Letter, Prudential Mobile Home Park Fund II

legislative history which indicated that the basis for the intrastate exemption was that the offering and its financing were local in character and adequately supervised by state regulatory agencies.[26] Sales of securities to foreign investors clearly indicated that the offering was not exclusively local.

In an unexpected reversal of its long-standing position, the SEC recently granted a no-action letter to an issuer selling common stock both to California investors and to citizens and residents of Hong Kong in reliance upon Rule 147.[27] The SEC stressed the importance of complying with subparagraphs (e) and (f) of Rule 147, including the nine-month holding period, and expressly rejected its earlier responses to no-action requests which had denied the availability of the intrastate exemption under similar circumstances. Although there was no analysis for the change, presumably, such a significant alteration represents a reasoned departure and a new administrative position on this issue which will be consistently interpreted. If so, the intrastate exemption may be of significant utility for a combined offering to foreign investors and the residents of a single state.

Private Placement Exemption

The other major exemption from registration is the private placement exemption of Section 4(2) of the Securities Act, which

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(March 13, 1973); SEC No-Action Letter, Seashore Invs. Inc. (Sept. 5, 1972); SEC No-Action Letter, Applied Aluminum Research Corp. (Sept. 13, 1972).

[26] In the release announcing the adoption of Rule 147, congressional intent and analysis of the intrastate exemption was explained thusly:

> Section 3(a)(11) was intended to allow issuers with localized operations to sell securities as part of a plan of local financing. Congress apparently believed that a company whose operations are restricted to one area should be able to raise money from investors in the immediate vicinity without having to register the securities with a federal agency. In theory, the investors would be protected both by their proximity to the issuer and by state regulation. Rule 147 reflects this Congressional intent and is limited in its application to transactions where state regulation will be most effective. The Commission has consistently taken the position that the exemption applies only to local financing provided by local investors for local companies. To satisfy the exemption, the entire issue must be offered and sold exclusively to residents of the state in which the issuer is resident and doing business. An offer or sale of part of the issue to a single nonresident will destroy the exemption for the entire issue. SEC Securities Act Release No. 5450 [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,617 (Jan. 7, 1974).

[27] SEC No-Action Letter, Scientific Mfg., Inc. (June 10, 1983).

provides that Section 5 shall not apply to "transactions by an issuer not involving any public offering."[28] Sales to a select group of sophisticated foreign investors in compliance with Section 4(2) are exempt from federal registration just as sales to comparable U.S. investors would be. In addition, a domestic private placement can include foreign investors without decreasing the number of U.S. citizens to whom the securities can be sold.[29]

With the passage of Rule 506,[30] the requirements for obtaining the private placement exemption have become increasingly objective. Although the exemption is now more attractive to issuers,[31] it has retained certain undesirable aspects. These include restrictions on transferability of securities and a limitation on the number of unaccredited investors to whom securities can be sold. Because of the disadvantages of the private placement exemption, and the inherent limitations of the intrastate exemption, real estate developers whose offerings constitute securities as to foreign investors should consider a nonstatutory exemption from registration.

Foreign Offering Exemption

The Securities Act grants the SEC jurisdiction over transactions involving "interstate commerce," which includes "trade

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[28] 15 U.S.C. § 77d(2) (1970).

[29] The Division of Corporation Finance has issued an opinion letter that foreign investors may be excluded from the total of thirty-five nonaccredited purchasers who may purchase partnership offerings under Rule 506. SEC No-Action Letter, American Real Estate Fund 82-A (Aug. 13, 1982). This is in accord with prior no-action positions taken with respect to Rule 146. SEC No-Action Letter, Salt Cay Beaches, Ltd. (Oct. 14, 1974).

[30] Securities Act Release No. 6389 (March 8, 1982), 17 C.F.R. § 230.501-230.506.

[31] Rule 506 is more predictable and easier to comply with than its predecessor, Rule 146, for several reasons. Wealth and sophistication standards apply only to purchasers, not to offerees, so that an offer to an unqualified investor does not, as it would under Rule 146, destroy the availability of the exemption provided that no sale is made to such an investor. Additionally, investors can be "accredited" based on eight objective standards. While retaining the Rule 146 limitation of thirty-five sales to unaccredited investors, Rule 506 permits the sale of securities to an unlimited number of accredited investors. See Powers, "Regulation D Offerings of Real Estate Syndication Interests: An Update," 3 Real Est. Sec. J. 37 (1982); Note, "Regulation D: Coherent Exemptions for Small Businesses Under the Securities Act of 1933," 24 Wm. & Mary L. Rev. 121 (1982).

or commerce in securities or any transportation or communication relating thereto among . . . or between any foreign country and any State, Territory, or the District of Columbia."[32] Thus, the use of U.S. mail or telephone in communicating offers, information, or acceptances regarding a security, even to a foreign investor, satisfies the minimum statutory requirements for SEC jurisdiction.

As a matter of administrative discretion, however, the SEC has chosen not to require registration of securities sold to foreign investors based upon the nonresident alien status of the investor and certain restrictions relating to the manner and method of the offering (the foreign offering exemption). The foreign offering exemption has numerous advantages because compliance is objectively determined and it imposes no limitation on the number or sophistication level of the investors. While transfers of the securities into the United States are not permitted immediately following the offering, purchasers are nonetheless free to transfer their interests outside of the United States.

The policy considerations for this administrative exemption are those included in the Commission's traditional position enunciated in a 1964 release (the Release) that the "registration requirements of Section 5 of the [Securities] Act are primarily intended to protect American investors."[33] Such protection is obtained if the offering precludes distribution or redistribution of the securities into the United States or to its nationals and "the securities com[e] to rest abroad."[34]

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[32] 15 U.S.C. § 77(b)(7) (1976). The term "interstate commerce" is also expansively defined in three other federal securities statutes: Exchange Act § 78c(a)(17); Investment Company Act of 1940 § 80a-2(a)(18), as amended; and Investment Advisers Act of 1940 § 80b-2(a)(10), as amended.

[33] SEC Securities Act Release No. 4708, 29 Fed. Reg. 9828 (July 9, 1964). For the SEC guidelines concerning the application of the federal securities laws to the offer and sale outside the United States of shares of registered open-end investment companies, see SEC Securities Act Release No. 5068, Securities Exchange Act Release No. 8907, Investment Company Act Release No. 6082.

In addition, non-United States citizens or residents are excluded from the computation of purchasers under Regulation D. See Securities Act Release No. 33-6455 (March 3, 1983), where in response to question number 56, the SEC affirmed that an offer to foreign investors need not be "integrated with a coincident domestic offering." The SEC is also proposing to expand the note to Rule 502(a) so that exempt offerings will not be integrated with certain foreign offerings.

[34] SEC Securities Act Release No. 4708.

Regrettably, the SEC has never adopted rules or regulations specifying the distribution mechanics to be satisfied to qualify for the foreign offering exemption. Acceptable procedures have been developed, however, through the issuance of no-action letters.[35] While most no-action responses regarding offshore sales have involved corporate debentures, bonds, or stock,[36] there have, nonetheless, been sufficient letters involving partnerships to provide guidance for the sale of real estate securities to foreign investors.[37]

Assuring That an Offering Will Remain Abroad

Two factors primarily determine whether an offering will come to rest abroad. First, only nonresident aliens may be

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[35] A "no-action letter" is interpretative advice offered by the SEC to an issuer in response to a particular factual situation. The SEC agrees that if the facts are as represented by the issuer, it will not take any enforcement action based on the described transaction. Although a no-action response applies only to the recipient and does not establish precedent, securities practitioners rely on the positions taken by the SEC, particularly with respect to well-developed areas such as the foreign offering exemption. For criticism and analysis of the no-action procedure, see Lowenfels, "SEC No-Action Letters: Conflicts With Existing Statutes, Cases and Commission Releases," 59 Va. L. Rev. 303 (1973); Lockhart, "SEC No-Action Letters: Informal Advice as a Discretionary Administrative Clearance," 37 Law & Contemp. Probs. 95 (1972); Lowenfels, "SEC "No-Action" Letters: Some Problems and Suggested Approaches," 71 Colum. L. Rev. 1256 (1971).

[36] For thorough listings of no-action letters with respect to debt financing and common stock offerings, see Note, "Extraterritorial Effect of the Registration Requirements of the Securities Act of 1933," 24 Vill. L. Rev. 729, 740-742 (1979); Johnson, note 6 *supra*, at 894-897.

[37] SEC No-Action Letter, L. Texas Petroleum, Inc. (Aug. 17, 1981) (no registration required for a simultaneous foreign stock offering and an exchange of limited partnership interests for outstanding common stock); SEC No-Action Letter, Pembroke Pines Plaza Assocs., Ltd. (Aug. 20, 1980) (no registration of limited partnership interests or mortgage notes required where sales are made exclusively to nonresident aliens); SEC No-Action Letter, Sanchez-O'Brien Oil & Gas Corp., [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,734 (June 23, 1980) (no registration required for sale of common stock of Netherlands Antilles corporation and interests in a Texas general partnership and/or interests in related oil and gas properties where preparatory activity occurs in the United States but all offerings, purchases, and deliveries and payments for the securities occur outside the United States and Canada); SEC No-Action Letter, ONEC Exploration, Ltd. (May 25, 1980) (no registration required for sale of Louisiana limited partnerships to European investors where the sales are made in compliance with the securities laws of the respective countries).

offered the securities. Second, following the initial sale of securities, the issuer must be able to prevent the resale or redistribution of the unregistered securities into the United States.

Offering materials must specify that securities will be offered and sold only to nonresident aliens, and the countries in which sales may be made are frequently indicated on the cover page of the offering circular. The cover page normally bears a legend stating that the securities have not been registered with the SEC and may not be sold, resold, or redistributed to residents or nationals of the United States. Most partnership offerings forbid redistribution into the United States for a minimum of twelve months following the termination of the offering.[38]

The subscription document and partnership agreement also contain representations and restrictions designed to effect compliance with the foreign offering exemption. Both documents require representations from the foreign investor that he is not a U.S. resident or citizen, that the interest is acquired with no intention of redistributing it into the United States, and that the foreign investor is the sole party in interest and is not seeking to divide the participation with others.[39]

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[38] The following legend from the ONEC Exploration, Ltd. no-action letter is representative of standard cover page disclosure:

> The Limited Partnership Interests have not been registered for offer or sale in or to citizens, residents or nationals of or institutions organized, chartered or resident in either the United States or Canada or their respective territories or possessions and the Limited Partnership Interests are not being offered and may not be sold directly or indirectly in the United States or Canada or their respective territories or possessions during the twelve-month period after completion of the sale of the Limited Partnership Interests and then only pursuant to a registration statement under the United States Securities Act of 1933 or pursuant to an exemption from registration under such Act.

[39] Typical restrictions are found in the ONEC Exploration, Ltd. no-action request, where all investors made the following representations:

> (a) The purchaser is not a citizen, resident, or national of or institution organized, chartered, or resident in the United States of America or Canada (including their territories or possessions), and is not purchasing on behalf of or in trust for any such parties.
>
> (b) The purchaser will not, under any circumstances, resell or redistribute the Limited Partnership Interest in whole or in part to any United States or Canadian citizen, resident, or national wherever located or to any institution

The issuer always runs the risk of losing the exemption if a foreign investor sells the unregistered security into the United States prematurely. The issuer can attempt to preserve the integrity of the foreign offering exemption by reserving to the U.S. general partner or venturer the absolute right to prohibit the sale, exchange, or assignment of the partnership interests or any other securities sold in the offering. The partnership agreement should provide that any attempted assignment or conveyance of a partnership interest in contravention of such provisions is null and void.

The issuer's joint venture or partnership agreement may impose limitations or prohibitions on the direct redistribution of partnership interests. As a practical matter, however, it is not always possible to police the redistribution of participations in the venture or partnership. Many foreign purchasers use corporations formed under the laws of the Netherlands Antilles or other tax haven countries as their investment vehicle. Shares in such corporations may be freely transferable bearer shares. Thus, a foreign investor can purchase the partnership interest through his Netherlands Antilles or other foreign corporation, and then redistribute the interest by selling or transferring the bearer shares of such corporation. An issuer can prevent this, at least in theory, by requiring foreign investors to deposit all shares of their purchasing entity in escrow with the issuer until the non-redistribution period has terminated.

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organized, chartered, or resident in the United States or Canada (or any of their respective territories or possessions), or to any party purchasing on behalf of or in trust for any such parties, unless a registration statement is in effect with respect to such resale or redistribution under the Securities Act of 1933 of the United States or an opinion of counsel (satisfactory to the general partners both as to opinion and counsel) is delivered to the Partnership to the effect that an exemption from registration under such Act exists. The purchaser recognizes that the availability of any such exemption depends upon facts and circumstances existing at the time of such reoffers and resales.

(c) The purchaser agrees to be bound by all of the terms and provisions of the Limited Partnership Agreement including the provisions thereof which prohibit a sale or transfer of any Limited Partnership Interest without the consent of the general partners.

(d) The purchaser represents that the Limited Partnership interest is being purchased for the purchaser's own account for investment only and not with a view to or with any intention of a distribution or a resale thereof in whole or in part or the grant of any participation therein.

A theoretical dilemma not addressed by the SEC or the courts is the problem of a foreign investor moving to the United States, and either establishing U.S. residence or citizenship during the non-redistribution period. Since the effect of such an action is arguably that the securities come to rest in the United States rather than abroad, change of residence or nationality by the foreign investor could destroy the basis for the foreign offering exemption. To guard against this circumstance, the foreign investor should represent that he will not become a U.S. citizen or resident until the termination of the non-redistribution period.

Certain offerings have, in addition, limited the use of advertising during the offering period. Issuers have agreed to refrain from making any public announcements, either in the United States or abroad, until all securities have been sold. This prohibition is presumably designed to discourage domestic investor interest during the non-redistribution period following termination of the offering, and thereby increase the probability that the securities will come to rest abroad and will not be sold into the United States.

Underwriting Agreement

If there is an underwriter, the underwriting agreement should require the broker-dealer to deliver an offering circular to each foreign investor, thereby notifying investors of all the restrictions on purchase and resale. Personal knowledge of the purchaser by each broker, the legends on the offering circular, and the execution of the subscription agreement with the appropriate representations contained therein should permit the underwriter and the issuer to conclude that each investor is qualified and that the foreign offering exemption is available.

Conclusion

The principles to be followed to obtain the foreign offering exemption may be gleaned by analysis of the Release and numerous no-action letters. Issuers, however, are presently engaging in the widespread use of an exemption that exists only by

administrative grace, and the parameters of which are inadequately delineated.

It is time for the SEC to accept responsibility in this area and adopt a non-exclusive safe harbor rule clarifying the foreign offering exemption. In addition, the state blue sky commissions should adopt a rule providing that issues that qualify for the federal foreign offering exemption should be automatically exempt from the registration requirements of the state blue sky laws. Promulgation of these rules at the federal and state level would have the beneficial impact of clarifying existing practice and conforming state and federal law. To this end, the author has drafted a proposed rule for consideration by the SEC which appears as Appendix A to this article. The rule defines nonresident aliens, provides for filings to permit the SEC to monitor these activities, and explicates the precise actions which must be taken to exempt an offering to foreign investors from the registration provisions. Adoption of this rule would make certain and predictable the treatment of numerous issues, which are now unnecessarily and unfairly subject to risk because of the absence of appropriate state and federal legislation.

APPENDIX A

Rule "X"

(a) *Definitions.* The following definitions shall apply for purposes of this rule.

(1) *Nonresident alien.* The term "nonresident alien" shall mean:

(A) As to a natural person, a person whose principal residence is without the United States and who is not a citizen of the United States;

(B) As to a corporation, a corporation incorporated under the laws of any jurisdiction without the United States; and

(C) As to a partnership or trust, a partnership or trust organized and existing under the laws of a jurisdiction without the United States.

Corporations, partnerships, and trusts shall not be deemed to be nonresident aliens if any legal or beneficial interest therein is owned, directly or indirectly by a United States citizen or resident, and the corporation, partnership, or trust was organized for the specific purpose of acquiring the securities offered.

(2) *Redistribution period.* The term "redistribution period" shall mean the period of time following the termination of the offering during which the securities cannot be resold or redistributed within the United States or to citizens, residents, or nationals of the United States. The redistribution period shall be six (6) months for all securities, except that the redistribution period shall be nine (9) months for securities sold in conjunction with an offering exempt from registration pursuant to Section 3(a)(11) of the Act or any rule or regulation promulgated thereunder.

(b) *Conditions to be met.* Transactions by an issuer involving the offer, offer to sell, offer for sale, or sale of securities of the issuer that are part of an offering that is made in accordance with all of the conditions of this rule shall be deemed to be exempt from the registration provisions of Section 5 of the Act.

(c) *Manner of offering.*

(1) Prior to the termination of the offering, neither the issuer nor any person acting on its behalf shall offer, offer to sell, offer for sale, or sell the securities by means of any solicitation or advertisement including any public announcement, advertisement, article, notice, or other communication published in any newspaper, magazine, or similar medium or broadcast over television or radio which is regularly circulated or received within the United States.

During the redistribution period, four copies of each of the following communications prepared or authorized by the issuer or anyone associated with the issuer, any of its affiliates, or any principal underwriter for use in connection with the offering of any securities under this regulation shall be filed, with the Commission at least five business days prior to any use thereof, or such shorter period as the Commission, in its discretion, may authorize:

(A) Every advertisement, article, or other communication proposed to be published in any newspaper, magazine, or other periodical and the script of every radio or television broadcast, which is regularly circulated, received, or transmitted within the United States, as the case may be:

(B) Every letter, circular, or other written communication proposed to be sent, given or otherwise communicated to more than five persons.

(2) Neither the issuer nor any person acting on its behalf shall offer, offer to sell, offer for sale, or sell the securities except to nonresident aliens, except that offers, offers to sell, offers for sale, or sale of securities may be made to citizens, residents, or nationals of the United States provided that all such offers or sales are made solely in connection with a transaction not involving a public offering in accordance with Section 4(2) of the Act, or any rule or regulation promulgated thereunder, or made solely in connection with a transaction effected in accordance with Section 3(a)(11) of the Act, or any rule or regulation promulgated thereunder.

(3) The offering may originate from within or without the United States and the securities may be offered or sold by the issuer, or domestic or foreign broker dealers.

(d) *Number of purchasers.* There shall be no limit on the number of nonresident aliens who may purchase securities hereunder.

(e) *Limitations on disposition.* The issuer and any person acting on its behalf shall exercise reasonable care to assure that securities sold in the offering come to rest abroad. Securities shall be deemed to have come to rest abroad if the securities are initially sold solely to nonresident aliens and the securities so sold are not resold or redistributed within the United States or to its citizens, residents, or nationals during the redistribution period. Reasonable care shall include, but not necessarily be limited to, the following:

(1) Making reasonable inquiry to determine that the purchaser is a nonresident alien acquiring the securities for his own account or on behalf of other persons;

(2) Placing a legend on the certificate or other document evidencing the securities stating that the securities have not been registered under the Act and setting forth or referring to the restrictions on transferability and sale of the securities;

(3) Issuing stop transfer instructions to the issuer's transfer agent, if any, with respect to the securities, or, if the issuer transfers its own securities, making a notation in the appropriate records of the issuer; and

(4) Obtaining from the purchaser a written agreement that the securities will not be sold without registration under the Act or exemption therefrom, and that the securities will not be offered or sold within the United States or to citizens, residents, or nationals of the United States during the redistribution period.

(f) *Filing of notice of offering.*

(1) The issuer shall file with the Commission four copies of a notice on Form "X" at the following times:

(A) No later than 15 days after the first sale of securities hereunder;

(B) Every six months after the first sale of securities in an offering made hereunder until the final notice required by paragraph (f)(1)(C) hereunder has been filed; and

(C) No later than 30 days after the last sale of securities in an offering hereunder.

(2) If the offering is completed within the 15 day period described in paragraph (f)(1)(A) of this rule and if the notice is filed no later than the end of that period but after the completion of the offering, then only one notice need be filed to comply with paragraphs (1)(A) and (1)(C) of this rule.

(3) One copy of every notice on Form "X" shall be manually signed by a person duly authorized by the issuer.

(4) A notice on Form "X" shall be considered filed with the Commission under paragraph (f)(1)(A) of this rule:

(A) As of the date on which it is received at the Commission's principal office in Washington, D.C.; or

(B) As of the date on which the notice is mailed by means of United States registered or certified mail to the Division of Corporation Finance, at the Commission's principal office in Washington, D.C., if the notice is delivered to such office after the date on which it is required to be filed.