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STATE SECURITIES REGULATION OF REAL ESTATE INVESTMENT TRUSTS

DAVID G. EPSTEIN

If one of John Saxe's blind men of Indostan were to prate about a real estate investment trust (REIT) with knowledge only of state securities regulations thereof, his commentary would be no more accurate or revealing than his descriptions of the elephant. For almost a decade, state blue sky regulation has presented the primary legal obstacle to the organization of real estate investment trusts. This article will consider the nature and problems of such regulation.

BACKGROUND AND CHARACTERISTICS OF REAL ESTATE INVESTMENT TRUSTS

History

Mid-nineteenth century Massachusetts law, which largely prohibited corporate ownership of real estate, led to the formation and widespread use of business trusts as instruments for real estate investment. The business trust has several characteristics common to the corporation: title to the assets of the real estate investment trust is held in the name of the trust by the trustees; the trustees issue shares in the trust that are freely transferable; and the trustees manage the assets of the trust pursuant to the declaration of trust. Notwithstanding these corporate attributes, real estate investment trusts were afforded the more favorable trust tax treatment until 1935.

Corporate income is subject to tax to the corporation regardless of whether it is retained or distributed to the shareholders. In addition, the shareholders are taxed on any distribution they receive from the corporation to the extent the corporation has earnings and profits. Thus, corporate earnings are subject to being taxed twice—first to the corporation, then to the shareholder upon distribution. A trust, however, is not taxed on income distributed to its

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5. See generally Hildebrand, The Massachusetts Trust, 1 Texas L. Rev. 127 (1923).
6. See text accompanying notes 9-10 infra.
8. Code §301.
beneficiaries;\textsuperscript{9} such income is taxable not to the trust but to the beneficiaries.\textsuperscript{10} Thus, income received by an REIT was not taxable to the trust to the extent distributed to the beneficial shareholders. Under this conduit concept, income tax was imposed only at the beneficial shareholder level as long as REIT earnings were distributed.

In 1935, however, this advantageous treatment was terminated. The Supreme Court, in \textit{Morrissey v. Commissioner}\textsuperscript{11} and three related cases,\textsuperscript{12} found the corporate characteristics reflected in the business trust sufficient to classify the trust as an “association” taxable as a corporation.

Most of the realty business trusts were soon liquidated.\textsuperscript{13} However, in 1960 Congress, in order to open real estate investments to small investors and to provide additional private capital for the real estate market,\textsuperscript{14} restored conduit tax treatment to real estate investment trusts with certain specified characteristics.\textsuperscript{15} The present popularity of REIT’s is largely attributable to the restoration of these favorable tax provisions.

\textit{Internal Revenue Code Provisions}

To be entitled to special tax treatment an REIT must comply with the statutory requirements set out in the Internal Revenue Code.\textsuperscript{16}

\textit{Unincorporated Trust or Association.} An REIT to obtain “conduit” tax treatment must be a common law business trust, having all the attributes of a corporation. It can be neither a corporation\textsuperscript{17} nor a limited partnership.\textsuperscript{18}

\textit{Ownership.} An REIT must have at least one hundred beneficial owners\textsuperscript{19} during 335 days of a taxable year of twelve months or during a proportional period of a shorter taxable year;\textsuperscript{20} and an REIT cannot be more than fifty per cent owned by five or fewer individuals.\textsuperscript{21}

\begin{itemize}
  \item \textsuperscript{10} CODE §652.
  \item \textsuperscript{11} 296 U.S. 344 (1935).
  \item \textsuperscript{13} 107 TAX MANAGEMENT, Real Estate Investment Trusts A-1 (1965).
  \item \textsuperscript{14} H.R. Rep. No. 2020, 86th Cong., 2d Sess. 2 (1960).
  \item \textsuperscript{15} CODE §§856-58. For a history of the legislation see Lynn, \textit{REIT's Problems and Prospects}, 31 Ford. L. Rev. 73, 76-79 (1962).
  \item \textsuperscript{16} CODE §§856-58. Numerous articles have considered these sections at length. E.g., Kilpatrick, \textit{Taxation of Real Estate Investment Trusts and Their Shareholders}, 39 TAXES 1042 (1961); MacDonald, \textit{Real Estate Investment Trusts Under the Internal Revenue Code of 1954, Proposals for Revisions}, 32 Geo. Wash. L. Rev. 808 (1964).
  \item \textsuperscript{17} CODE §856; Treas. Reg. §1.856-1 (b) (3) (1962).
  \item \textsuperscript{18} CODE §761 (a) excludes corporations and trusts from the definition of “partnership.”
  \item \textsuperscript{19} CODE §856 (a) (5); Treas. Reg. §1.856-1 (b) (5) (1962).
  \item \textsuperscript{20} CODE §856 (b); Treas. Reg. §1.856-1 (c) (1962).
  \item \textsuperscript{21} CODE §856 (a) (6); Treas. Reg. §§1.856-1 (b) (6), (d) (5) (1962).
\end{itemize}
Transferable Shares. REIT ownership must be “evidenced by transferable shares or by transferable certificates of beneficial ownership.”

Management by Trustees. An REIT must be “managed by one or more trustees” who may be individuals or corporations. The trustees “must have continuing exclusive authority over the management of the [REIT], the conduct of its affairs, and . . . the management and disposition of the [REIT’s] property.”

Sales. An REIT cannot hold property “primarily for sale to customers in the ordinary course of its trade or business.” In addition, less than thirty percent of the annual gross income of an REIT can be derived from sales of securities held for less than six months or sales of real estate held for less than four years (except for involuntary conversions).

Distribution of Income. An REIT must annually distribute to its shareholders at least ninety percent of its ordinary taxable income. The trust then pays a tax only on the income that it retains and does not distribute as dividends. If it distributes all of its income, it pays no tax. To the extent that it distributes capital gains to its shareholders, no tax is payable by the trust. On retained long-term capital gains, it is taxed at the standard capital gains rate.

Election. To obtain the benefits of the REIT provisions of the Code, the trust must make an affirmative, irrevocable election. It does so merely by computing its taxable income as an REIT on its return.

Asset Test. Two tests, similar to those required of mutual funds, must be met by an REIT. First, at the close of each quarter of the taxable year at least seventy-five percent of the value of the trust’s total assets must be represented by: (a) real estate assets, which include real property, including both interests in real property and in mortgages on real property, and shares on other qualifying REIT’s. “Interests in real property” include co-ownership of land and improvements and leaseholds of land and their improve-

24. Treas. Reg. §1.856-1(d)(1) (1962). It is unclear how much authority can be given to shareholders without jeopardizing loss of real estate investment trust qualification. The above cited regulation contains examples of permissible shareholder power.
32. Code §856(c)(5)(A).
33. Code §856(c)(6)(B).
ments, but not mineral, oil, or gas royalty interest; 34 (b) cash and cash items, 35 which include receivables arising in the ordinary course of the trust's operations but not receivables purchased from another person; 36 (c) government securities. 37

Second, no more than twenty-five per cent of the trust's assets at the close of each quarter of the taxable year can be represented by corporate securities. 38 In addition, the trust cannot own securities of any one issuer worth more than five per cent of the value of the total assets of the trust or no more than ten per cent of the outstanding voting securities of an issuer. 40

Income Requirements. The latitude of investment permitted by the asset tests is diminished by the income source provisions. The requirement that at least seventy-five per cent of the income be from certain types of real estate interests necessitates an REIT's having the predominant part of its assets in productive real property. Another fifteen percent of the trust's gross income must come from either real estate or from investment sources. 42 Finally, as noted above, less than thirty per cent of the gross income of the trust can come from the sale of securities held less than six months or from the sale of real property held for less than four years. 43

Types of REIT's

Real estate investment trusts may be divided into two main classes: those that invest primarily in equity interest in real property and those that invest primarily in mortgage loans. Although the basic objective, that is, return on capital, is the same in both the equity oriented and the mortgage oriented REIT's, their methods of operation and their performances in the market place are quite different. The equity oriented REIT seeks to acquire properties with a predictable and favorable cash flow with a view to long-term appreciation in value. Thus, equity REIT's provide an investment vehicle to those interested primarily in long-term capital gains.

Mortgage oriented REIT's, on the other hand, attempt to maximize their return to shareholders by making a variety of relatively short-term investments and otherwise tailoring their investment policies to respond quickly to changes in interest rates and by leveraging their capital wherever possible to increase the shareholders' return. The relatively high yield in the shares

34. Code §856 (c) (5) (C).
35. Code §856 (c) (5) (A).
37. Code §856 (c) (5) (A).
38. Code §856 (c) (5) (B); Treas. Reg. §1.856-2 (d) (2).
39. Code §856 (c) (5) (B); Treas. Reg. §1.856-2 (d) (2).
40. Code §856 (c) (5) (B); Treas. Reg. §1.856-2 (d) (2).
41. Code §856 (c) (3).
42. Code §§856 (c) (2)- (3).
43. Code §856 (c) (4); Treas. Reg. §1.856-2 (c) (iii).
of mortgage oriented REIT's has tended to result in increases in market value and consequent capital gains to shareholders. Shares of mortgage oriented REIT's consequently tend to appeal to investors interested in income as well as capital appreciation and therefore sell in the market place at prices that are related to earnings performance, much the same as an industrial company. Although the first real estate investment trusts were almost all equity trusts, there was a "rash" of mortgage trusts in the spring of 1969, which has continued.44

Organization

The organization of a real estate investment trust is quite similar to the organization of a corporation. The trust's declaration of trust is roughly comparable to a corporation's articles—the trustees' regulations to corporate bylaws. And, just as most corporations are organized in Delaware to take advantage of that state's established and generally permissive corporate code, most REIT's are formed in Massachusetts.45

Most trustees of real estate investment trusts, like most directors of a business corporation, do not devote their full time to the affairs of the trust, and they usually receive only nominal compensation. The day-to-day managerial operations are customarily entrusted to an investment adviser. If an investment adviser is employed, he ordinarily selects and processes investment opportunities, which are then presented to the trustees or to a committee.

44. See Nelson, Regulation of REIT's by the Midwestern States, in Practising Law Institute, Real Estate Investment Trusts (Real Estate Law and Practice Course Handbook ser. No. 17) 95, 96 (1969).

45. "In a few states REIT's are not authorized at all because statutes prohibit creation of express trusts for other than certain specified purposes and none of these is broad enough to include the real estate investment trust." See generally ABA, Real Estate Investment Trusts, 16 Bus. Law. 900, 901 (1961). In many other states the status of business trusts is uncertain. "[T]here has been little state legislation regarding the validity of REIT's and the powers, rights, and duties under them." G. Bogert, The Law of Trust and Trustees, §249, at 90 (2d ed. 1964). Thus, questions remain concerning shareholder liability, trust duration, the necessity for registration as a foreign corporation, exemption from local corporation taxes, et cetera. To further complicate matters, state courts are divided in determining whether to apply the law of the forum or the law of the trust's state of origin with respect to such incidents of trust character as personal liability of shareholders. See Comment, Limited Liability of Shareholders in Real Estate Investment Trusts and the Conflict of Laws, 50 Calif. L. Rev. 696, 702 n.41 (1962); Note, The Real Estate Investment Trust in Multistate Activity, 48 Va. L. Rev. 1125 (1962). Accordingly, trusts doing their principal business in numerous other states have formed trusts in Massachusetts. This has been done even though the states of principal place of business allowed REIT's to be formed. See Dockser, Real Investment Trusts: An Old Business Form Revitalized, 17 U. Miami L. Rev. 115, 121 (1962). Use of Massachusetts as the state of organization does not result in any additional state taxes; an REIT is not subject to any income tax in Massachusetts provided there is distribution of all taxable income from sources in Massachusetts. See North American Mortgage Investors, Prospectus, May 12, 1970, at 19. Of course, regardless of state of organization, an REIT may be subject to local taxes in the other jurisdictions in which the REIT may be deemed to be doing business or in which properties securing loans by the trust may be located.
of trustees for approval. The adviser may also service a mortgage loan portfolio and perform other similar functions.

In all prospectuses examined the promoters or their affiliates serve as both investment advisers and independent contractors. Consider, for example, the Wachovia Realty Investments (WRI) prospectus. WRI has entered into a service and advisory agreement with Wachovia Mortgage Company (WMC), a subsidiary of the Wachovia Corporation. Under the agreement WMC shall: "be compensated at the monthly rate of $1/10th of 1% of the daily average book value of the investments (excluding (i) government bonds, except for securities of the Federal Housing Administration or Federal National Mortgage Association, and (ii) cash and cash items) of the Trust. . . ." plus: "an incentive fee equal to 10% of the amount by which the net profit of the Trust (after payment to the Adviser of the fees referred to above and as otherwise defined in the Advisory Agreement) exceeds 8% per annum of the monthly average net worth of the Trust."

Applicability of Securities Laws

Another REIT-corporation similarity is the applicability of federal and state securities laws to REIT's. An interest in a real estate investment trust is a security for purposes of the federal and state securities laws and, accordingly, the filing of a registration statement with the Securities and Exchange Commission is generally required.

In view of the obvious similarity between REIT's and mutual funds it might be expected that REIT's would be regulated by the Investment Company Act of 1940 adopted by Congress to regulate investment funds. That Act, however, provides an exclusion for companies primarily engaged in purchasing and acquiring real estate interests, including liens and mortgages, that do not issue face amount certificates of the installment type. Consequently, it is not expected that any real estate investment trust qualifying

47. Id. at 25.
48. Id.
50. 15 U.S.C. §773 (1964). The registration is required absent the applicability of one of the statutory exemptions set forth therein. While it might seem that either the private offering exemption or the intrastate offering exemption would apply to real estate investment trust issues, neither has been widely used. To qualify as a real estate investment trust an entity must have 100 or more shareholders. An offering of this size would not be a private offering in any except the most unusual factual circumstances. The requirements of the intrastate offering exemption are that the REIT shares be offered and sold only to residents of the one state in which the REIT is organized and in which it is doing business. Essentially, the trustees and shareholders should be residents of the relevant state, the principal trust property should be situated in that state, and the trust should be organized and governed by the law of the relevant state. Reliance on the intrastate exemption is improvident due to the REIT requirement of transferability of shares and the usual scope of REIT activity.
52. 15 U.S.C. §80a-3 (c) (6) (c) (1964).
under the Internal Revenue Code provisions will be subject to the Investment Company Act of 1940.58

As with corporate securities, there must be compliance not only with the federal requirements but also with those of every state in which REIT shares are to be sold.

**STATUS OF PRESENT STATE SECURITIES REGULATION OF REIT'S**

It is unrealistic to examine state securities regulation of real estate investment trusts without considering state securities regulation in general. State blue sky laws have come under increasing attack in recent years.54 As one law review commentator stated:55

The blue sky laws had come to have a special meaning—a meaning full of complexities, surprises, unsuspected liabilities for transactions normal and usual—in short, a crazy quilt of state regulations no longer significant or meaningful in purpose and usually stultifying in effect or just plain useless.

Criticism has focused primarily on the lack of certainty and uniformity in the state regulation. Most states have no published administrative rules or guidelines. Thus, prefiling conferences with the administrator or his staff frequently are necessary in order to decide whether to register and to effect the registration. If the offering is to be in a number of states it probably will be necessary to refer the matter to a blue sky law specialist in some financial center. As Loss and Cowett in their treatise on state securities laws noted: "Only those lawyers who devote a substantial amount of their practice to blue sky matters develop the expertise necessary to bring order out of the statutory and administrative morass."56

Moreover, bringing "order out of the statutory and administrative morass" of State X will be of limited assistance in State Y. Although twenty-five states have enacted statutes patterned after the Uniform Securities Act,57 few legislatures have resisted the urge to modify Professor Loss’s handiwork. Less than one-half of these states have enacted substantially all of the Uniform Act. More significantly, the regulations promulgated pursuant to the Act vary from state to state. Section 412A of the Act provides in pertinent part:

The [Administrator] may from time to time make, amend, and rescind such rules, forms and orders as are necessary to carry out the provisions

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56. L. Loss & E. Cowett, BLUE SKY LAWS 44 (1958). This was recently affirmed in Hayes, State Regulation of Securities Issues, 17 DRAKE L. REV. 170, 171 (1968).
57. See BLUE SKY L. REV. §4901. Nevada and New Jersey, although listed there, have adopted only the broker-dealer provisions of the Uniform Act.
of this act, including ... defining any terms, whether or not used in this act.

Due to this extremely broad rulemaking power, regulations vary greatly from state to state and regulations generally have more impact than statutory provisions.58

Lack of certainty and lack of uniformity are particularly acute problems in the REIT area. The published securities laws and rules of most states make no mention of real estate investment trusts. This, however, does not necessarily mean that all these states have no securities regulations directed specifically to REIT's. For example, until October 1970 Texas followed a suggested statement of policy written in 1962 that has never been formally adopted or printed in any standard reference work.59

The most significant state securities regulation of real estate investment trusts is the Midwest Statement of Policy. In 1961 the Midwest Securities Commissioners Association60 promulgated a policy statement on real estate investment trusts. The member states of the Midwest Securities Commissioners Association are not bound by this statement of policy, and many recent REIT offerings that qualified in most of the member states do not completely comply with the Midwest statement. Further, some of the member states have adopted their own provisions that differ from the Midwest Statement of Policy.

Compounding the confusion, a number of other states, not part of the Midwest Association, have adopted the Statement of Policy as a guide. It is difficult to state with certainty the number of states in this category. The principal repository of state securities regulations — Blue Sky Law Reporter — indicates only two non-Midwest states as having adopted the Midwest policy statement.61 A number of additional states, however, also take this position. Written inquiry was made to the non-Midwest states; of the twenty that replied, eight indicated some degree of adherence to the Midwest Policy Statement.62

Another letter stated:63

While we do not explicitly abide by the Mid-West Statement of Policy, we look to the experience of the applicants ... and if such experience

60. The association is composed of the securities commissioners of Arizona, Arkansas, California, Colorado, Illinois, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Missouri, Nebraska, New Mexico, North Dakota, Ohio, Oklahoma, South Dakota, Texas, and Wisconsin.
61. Mississippi, BLUE SKY L. REP. ¶27,641; Tennessee, BLUE SKY L. REP. ¶45,626.
62. Alaska, Hawaii, Louisiana, Montana, Oregon, South Carolina, South Dakota, and West Virginia.
indicates a departure from the Mid-West Policy, then such proposed offering will be closely scrutinized.

In this focus, an extended consideration of the Midwest Statement of Policy seems merited.

**Midwest Statement of Policy Regarding REIT's**

In the past ten years there has been a series of real estate investment trust statements of policy by the Midwest Commissioners. The first, promulgated in February 1961 was soon replaced by a less restrictive policy statement in October 1961. This policy statement endured until July 6, 1970, when the policy statement now in effect was adopted. The provisions in the present Midwest Statement of Policy can be divided into two categories: internal structure and general investment policies. It is in the former that the primary changes have occurred.

**Internal Structure**

The October 1961 policy statement detailed the organizational structure REIT's were to use. A trust was required to have a minimum of three trustees whose term was to be no more than three years, quarterly and annual reports, annual stockholders meetings, special meetings callable at the written requests of persons holding at least twenty-five per cent of the outstanding voting shares, removal of trustees, change in trust declaration, and termination of the trust on the vote of the holders of two-thirds of the outstanding shares. All of these requirements have been eliminated; the organizational provisions of the existing policy statement focus primarily on insider profits.

Real estate investment trusts present “unlimited potentialities for self-dealing.” Consider the organization of the typical mortgage REIT — organized by a mortgage banker and advised by an entity affiliated with the mortgage banker. Certainly some protection from insider profits would seem desirable.

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66. BLUE SKY L. REP. ¶4801 [hereinafter cited as MIDWEST POLICY STATEMENT].
68. Id.
70. 1961 POLICY 5.
73. 1961 POLICY 9.
74. 1961 POLICY 10.
75. Nelson, supra note 44, at 96.
The limitations imposed by the Midwest Statement of Policy take three forms: restricted self-dealing, limited advisory fees, and a requirement that a majority of the trustees not be affiliated with the trust.

Under the October 1961 policy statement an REIT could not sell assets to or buy assets from its trustees, advisors, or employees with an interest in the organization except at the inception of the trust, and then only if the trading insider received no commission and the price was at an appraised value acceptable to the state commissioner. This limitation was widely condemned as being unduly restrictive, serving to discourage knowledgeable real estate people from participating in real estate investment trusts and depriving the trusts of promising investment opportunities.

The present policy statement enumerates four situations where such insider dealing may occur:

1. acquiring property at the inception of the trust;
2. acquiring insured or guaranteed mortgages for no more than the federal National Mortgage Association quoted price;
3. acquiring mortgages on terms comparable to similar "arms length" transactions;
4. acquiring other property at prices not more than the independent appraisal.

Additionally, before the trust enters into any such transactions the interests of the parties involved must be disclosed and the transaction approved by both a majority of the trustees and a majority of the independent trustees. Commissions on such transactions are permitted, but they must be deducted from the management or advisory fee. These provisions should be contrasted with the present trend in corporate law to recognize interested director transactions approved by a majority of the independent directors without any requirement of outside appraisal.

The present Midwest Statement of Policy does not specifically prescribe a maximum amount of percentage for investment advisor and independent contractor fees. Rather, all REIT expenses are consolidated and subjected to the following limitation:

The aggregate annual expenses of every character paid or incurred by the trust excluding interest, taxes, expenses in connection with the issuance of securities, shareholder relations, and acquisition, operation maintenance, protection and disposition of trust properties but including advisory fees and mortgage servicing fees and all other ex-
penses shall not exceed the greater of (1) 1.5% of the average net assets of the trust . . . or, (2) 25% of the net income of the trust . . .

The previous Midwest policy statement limited the total compensation of the investment adviser to one-half of one per cent of the net assets managed.\textsuperscript{88} The October 1961 Midwest rules also placed a limitation of one per cent of net assets or 5,000 dollars, whichever was greater, on aggregate expenses of every character, "exclusive of interest, taxes, maintenance and upkeep of trust assets, payments to independent contractors, compensation to investment adviser, reasonable sales commissions in the disposition of properties, legal fees relating to acquisition of real estate, and title insurance or abstract expenses."\textsuperscript{84}

There is at least some question whether the present maximum limitation is reasonable. Most investment adviser fees computed under the 1961 policy statement exceeded the one per cent standard.\textsuperscript{85} The California test — two per cent of the first $10 million of base assets,\textsuperscript{86} one per cent of the excess base assets\textsuperscript{87} — is perhaps more realistic.

The present Midwest provisions also raise numerous constructional problems. Consider, for example, the investment adviser compensation plan set out in the recent North American Mortgage Investor prospectus. In addition to compensation from the trust, the adviser "may also receive commissions for placing mortgages with the Trust."\textsuperscript{88} Similarly, an investment adviser for an equity trust may well receive commissions from the sellers of property to the trust. Are the commissions paid to the investment adviser by third parties to be considered in determining whether the one-and-a-half per cent limitation has been exceeded? The language of the policy statement is that "[a]ll commissions or remuneration received by any such person in connection with any such transactions shall be deducted from the advisory fee."\textsuperscript{89} There is no express limitation on the source of the commission. Moreover, the October 1961 limitation seemed clearly directed to REIT payments to the investment adviser, as payments by third parties were not covered.\textsuperscript{90} This clarity is not lacking.

A second question that may well arise is whether the one-and-one-half per cent expense limitation impliedly limits the amount of commission or remuneration that the investment adviser or trustee may receive in connection with the sale of land to the trust. Such a situation may well arise in the

\textsuperscript{83.} 1961 POLICY 11.
\textsuperscript{84.} 1961 POLICY 12 (b).
\textsuperscript{86.} 1 Blue Sky L. Rep. \#8625 (1970). "Base assets" is there defined as "total assets under management, less cash, cash items and except in the case of a first mortgage trust, unsecured indebtedness."
\textsuperscript{87.} Id. For a general discussion of the California REIT provisions, see H. Marsh & R. Volk, Practice Under the California Corporate Securities Law of 1968, 308-12 (1969).
\textsuperscript{89.} Midwest Policy Statement B.
\textsuperscript{90.} 1961 POLICY 12 (b).
organizational period of an equity trust. The trust, because of its initial public offering, will often have cash assets of millions of dollars to invest in real estate. It will want to invest as much of this as soon as possible in real estate in order to qualify as a real estate investment trust. If the investment adviser receives a ten per cent commission from the seller on each parcel of land acquired by the trust, the commissions will probably exceed one-and-one-half per cent of the assets of the trust. Will he have to refund the excess to the trust? Will this in some way affect the fees he can receive from the trust in future years? Will this result in sanctions being imposed against the trust by states following the Midwest policy?

General Investment Policy

The present policy statement allows the trustees considerably more freedom in investments than previous policy statements. Only two substantial restrictions remain. A trust shall not invest more than ten per cent of its assets in non-wraparound junior mortgages. Likewise, a ten per cent limitation is imposed on investments in “unimproved real property or mortgages on unimproved real property excluding property that is being developed or will be developed within a reasonable period.” The latter restriction is the more controversial and questionable.

Originally, the Midwest prohibition on investment in unimproved lands and mortgages on the same was absolute; the prohibition was thought to be tax oriented because investments of such a nature would disqualify the trust from the favored tax treatment. Subsequent policy statements, however, relaxed the restriction somewhat. The October 1961 statement prohibited investment in mortgages on unimproved land and limited investments in unimproved real property to five per cent of the assets of the trust, which “includes among other things, vacant land, lots on which permanent buildings have not been completed and agricultural or ranching land. Agricultural or ranching land which is purchased at substantially its value for agricultural and ranching land and used as such shall not be regarded as unimproved property.” In light of the five per cent investment permitted in 1961 and the ten

91. MIDWEST POLICY STATEMENT F(2). Generally, if the owner of a real property encumbered by a mortgage refinances, the existing first mortgage loan is repaid from the proceeds of the new loan. It may be desirable, however, to preserve the existing first mortgage because of certain of its terms, such as a lower interest rate. In wraparound second mortgage financing the principal amount of the second mortgage note is equal to the sum of the outstanding balance under the first mortgage loan and the amount actually to be advanced under the second mortgage loan. The second mortgagee assumes payment of the first mortgage loan.

92. MIDWEST POLICY STATEMENT F(1).


94. Meeting with Mr. King of the Texas Securities Board, July 24, 1970.

95. 1961 POLICY 14 (a).
per cent allowable today, it appears that the motivation for the restriction is other than tax oriented. Rather, this seems to be an attempt to legislate conservative management.\(^\text{96}\)

It should be remembered that in enacting REIT legislation Congress was motivated by a desire that the "small investor" secure advantages normally available only to those with larger resources. The greatest profits to be made in real estate investment are acquired by capturing the rapid appreciation in land value occurring when the demand for a changed land utilization dictates a more intensive use of a parcel of land. This often occurs with farm land adjacent to urban areas, particularly in rapidly urbanizing areas such as Florida, California, and Arizona. Thus, the ten per cent limitation eliminates a great area of investment for the real estate investment trust and, consequently, for the small investor.

The unimproved property limitation is not only inconsistent with stated congressional intent but is also at odds with state treatment of undeveloped land sales. In 1967 fourteen of the twenty-five states constituting the Midwest Securities Commission had no state regulation of the sale of undeveloped land.\(^\text{97}\)

The California Corporate Securities Law contained prohibitions of REIT investment in non-income producing property similar to the present Midwest provisions until 1968.\(^\text{98}\) According to the principal draftsmen of the present California law:\(^\text{99}\)

> These prohibitions have been eliminated... as contrary to the accepted California practice with respect to real estate investment and lending. It is believed by the authors that such prohibitions substantially deterred the sale of REIT securities in California and were not founded on any defensible public policy.

To discuss the state securities regulation of real estate investment trusts by states other than California and the member states of the Midwest Securities Commissioner would be to "prate about an elephant not one of them has seen."\(^\text{100}\) Past actions (and inactions) would seem to indicate that most "non-Midwest" states will also view with disfavor REIT's that contemplate substantial investments in undeveloped land.

In focusing on specific problems with the present Midwest Statement of Policy, one should not lose sight of the primary problem in state regulation of real estate investment trusts—the absence of clear and meaningful guide-


\(^{98}\) See H. Marsh & R. Volk, supra note 87, at 311.

\(^{99}\) Id. at 311-12; cf. Godfrey & Bernstein, supra note 64, at 664.

lines. This lack of clarity and certainty is more significant than any constructive problem or even policy question raised by the Midwest Statement. Uniformity, while very desirable, is not presently realistic. Every state could, however, at least formally indicate whether it treats real estate investment trust registrations the same as corporate stock offerings and, if not, delineate the special guidelines applicable to real estate investment trusts.