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July 18, 2012

Roger N. Walter, Esq.
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RE: Interpretive Opinion No. 2013-001, ReVest Rentals, LLC

Synopsis: The proposed mortgage notes to be issued by ReVest Rentals, LLC ("ReVest") to private investors are securities as defined under K.S.A. 17-12a-101(28). In light of the substance rather than the plain words of the agreement, the *Reves* exception for notes secured by a mortgage on a home is inapplicable and no alternative "family resemblance" applies.

Dear Mr. Walter:

In your letter dated March 29, 2012, you request confirmation that the notes issued by ReVest Rentals, LLC. ("ReVest") would not be subject to regulation under the Kansas Uniform Securities Act. As we understand the request, ReVest's position is that the notes do not constitute securities within the meaning of K.S.A. 17-12a101(28), and through the application of the *Reves* and *Howey* tests.

I incorporate by reference the facts as represented in your letter. ReVest is principally engaged in the business of buying distressed residential real estate, rehabilitating the property, and then leasing the property, with or without an option provided to the lessee to purchase the property ("lease option"). ReVest markets its lease option properties to buyers who are otherwise not qualified for conventional mortgage financing, but who may become qualified in the future. Your letter does not disclose the financing arrangement of lessees who exercise the purchase option, but whether the financing is through ReVest or through a bank does not change the outcome of our analysis. ReVest currently finances its business operations through lines of credit with two major banks. ReVest is seeking to augment its operations by seeking private investors. ReVest proposes to refinance the properties subject to leases with purchase options by offering mortgage notes to single purchasers who would qualify as accredited investors. The notes with mortgages will be sold as a unit without fractionalization. ReVest plans to seek accredited investors through general solicitation. The proceeds from mortgage notes would replenish the operating capital of ReVest to enable the continued purchase and renovation of additional properties. The proposed note shows that ReVest would be the borrower and the accredited investors would be identified as lenders to ReVest.

As correctly stated in your letter, the question of whether a note is a security depends upon the application of the "family resemblance" test set forth in *Reves v. Ernst & Young*, 494 U.S. 56 (1990). In *Reves*, the Supreme Court recognized that not all notes are securities. They established the "family resemblance" test, which presumes that a note is a security unless it bears a strong family resemblance to certain types of notes deemed to be outside of the investment market regulated by the securities laws and thus not securities. Among the notes that the court held to be securities is a "note secured by a mortgage on a

home." Four factors must be considered when determining whether a note bears a "strong family resemblance" to an excluded note:

> "First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security." ... Second, we examine the "plan of distribution" of the instrument ... to determine whether it is an instrument in which there is "common trading for speculation or investment." ... Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction... Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary." *Reves v. Ernst & Young*, 494 U.S. 56, 66-67 (1990).

Though *Reves* found that a note secured by a mortgage on a home is not a security, we find that the instant situation is factually different from the traditional mortgage that we believe *Reves* addresses. Traditionally, mortgage notes are issued by regulated financial institutions, mortgage companies, or the individual seller of the property. Here, ReVest, the borrower, is not financing a person's residence as would be a homebuyer, but rather is in the business of buying, renting and selling residential properties for profit, and is using the notes simply as a source of funding for their general business activities. Additionally, ReVest proposes to sell the notes to accredited investors are entering the transaction with the primary interest of making a profit. Accordingly, this arrangement qualifies as a security under the first factor of *Reves* because the motivations of the buyer and seller are to provide investment capital for the operation of ReVest with an expectation of profits on the disposition of properties.

Looking at the second factor in *Reves*, the plan of distribution of the notes by ReVest is more similar to an offering of securities to the general public (who qualify as accredited investors) rather than the manner in which a non-security loan transaction would occur. In a typical home loan transaction, the borrower applies to the lender rather than as proposed by ReVest whereby it, as issuer and borrower, solicits investor-lenders.

The third *Reves* factor is satisfied because the public is likely to view this arrangement as a security that one invests in with the intent of making a profit. As explained above, this arrangement differs from traditional mortgage loans because the borrower is soliciting lenders rather than the lender soliciting borrowers. In this sense, the arrangement is more like an investment with a fixed rate of return and security interest than a traditional mortgage.

Lastly, the notes to be issued by ReVest lack the type of risk mitigating qualities that allow an instrument to avoid the application of the Securities Act under the fourth factor. ReVest's notes would not be subject to regulation by another agency and the risk involved with these notes would be greater than risks involved with mortgage loans issued by regulated financial institutions and mortgage companies. This is due to the fact of ReVest's ability to pay their loans and avoid default rests primarily upon a high-risk lessee making their payments, and the shorter than average five-year rate of maturity. These factors increase the likelihood that the lessee will default, and volatility in the market or damage to the property could leave the investor without an adequate security interest. Though the opportunity to invest is limited to accredited investors, those investors will face a higher financial burden should they lose their

investment than the average financial institution. Accordingly, ReVest's notes should be considered a security subject to the Securities Act under the *Reves* analysis.

Additionally, the arrangement qualifies as a security by virtue of being an investment contract as analyzed in *SEC v. W.J. Howey Co.*, 323 U.S. 293 (1946). In *Howey*, the Supreme Court found that an investment contract exists when a person: 1) invests money, 2) in a common enterprise, 3) with the expectation of profit, 4) from the efforts of others. *Id.* at 301. The Kansas Supreme Court adopted this test in *Activator Supply Co. v. Wurth*, 239 Kan. 610 (1986); *see also State ex rel. Owens v. Colby*, 231 Kan. 498 (1982).

An "investment of money" requires only that the investor "commit his assets to the enterprise in such a manner as to subject himself to financial loss." *Activator Supply*, 239 Kan. at 617. Here, this is satisfied because the investors are exposed to the risk that lessees will default and that they will be unable to either recoup their investment due to a decline in the value of the home, due to market changes, or damage to the property.

The second prong, "common enterprise," can be satisfied in Kansas by either vertical or horizontal commonality between the investor and the promoter. *See 537721 Ontario, Inc., v. Mays*, 14 Kan. App. 2d 1, 4, 780 P.2d 1126 (1989). Vertical commonality means that the "fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties." *Activator Supply*, 239 Kan. at 618. Horizontal commonality requires that there is "joint participation by all investors in the same investment enterprise. It requires that the investors provide capital and share in the earnings and profits." *537721 Ontario*, 14 Kan. App. 2d at 3-4. Here, the arrangement between ReVest and the investors satisfies the requirements of vertical commonality. The investors' ability to recoup on their investment is dependent in part on the business decisions of ReVest. For the investor to make a return on their investment, ReVest must successfully market their properties, sign tenants, collect rent, and otherwise run their company well. In turn, this satisfies the third prong, the investor's "expectation of profit."

The final prong requires that the expected profits come from the efforts of others. The Kansas Supreme Court has held that "the test to be applied is whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise. To hold otherwise would make it easy to evade the existence of an investment contract by adding a requirement in the contract that the buyer contribute a modicum of effort." *Activator Supply*, 239 Kan. at 620. Here the investors will be dependent upon the business skills and decision-making abilities of ReVest management. The investors will be passive with respect to actions they could take to select appropriate lease option candidates, ensure payments of interest and repayment of the principal on the note. Additionally, investors will be dependent upon ReVest management to provide adequate disclosure of information about the properties financed, such as costs, fair value, rental or lease rates, etc., so as to avoid deterioration of profits from legal disputes.

Accordingly, staff concludes that the proposed notes to be issued by ReVest Rentals, LLC are securities and will require registration under the Act, unless offers and sales comply with a valid exemption. ReVest may want to determine if a registration exemption is available under the Act.

One possible exemption may be the Invest Kansas Exemption (IKE), as set forth in K.A.R. 81-5-21. However, if ReVest remains committed to making the offering available to accredited investors only, the exemption under K.A.R. 81-5-13 may be more relevant. ReVest could use K.A.R. 81-5-13 (which is designed for compliance with SEC Rule 504(b)(iii)), although that would also limit the aggregate offering to $1,000,000 (as would IKE). K.A.R. 81-5-13 could also be used in conjunction with SEC Rule 147 for an intrastate offering without an aggregate offering limitation as under Rule 504.

Another possibility would be to defer the offering until the SEC amends Rule 506 as required under Sec. 201 of H.R. 3606, Jumpstart Our Business Startups Act (the "JOBS Act") to allow for general solicitation to attract accredited investors. When the amended Rule 506 is in effect, that exemption could be claimed without a dollar limitation and a notice could be filed with our office as required under K.A.R. 81-5-15. This opinion is based upon the facts as represented in your letter. Any variance from those facts could result in a different conclusion. Please be advised that this opinion is intended solely as an expression of enforcement policy and is not binding on any court or other tribunal.

Sincerely

JEFFREY S. KRUSKE
General Counsel