

In certain cases the “lender” has virtually the same potential rewards as those of an owner or a joint venturer by virtue of participating in expected residual profit.⁶ In addition, Exhibit I to PB1 includes a number of other characteristics which, when considered individually or in combination, would suggest that the risks of an ADC arrangement are similar to those associated with an investment in real estate or a joint venture or, conversely, that they are similar to those associated with a loan. Among those other characteristics is whether the lender agrees to provide all or substantially all necessary funds to acquire the property, resulting in the borrower having title to, but little or no equity in, the underlying property. The staff believes that the borrower’s equity in the property is adequate to support accounting for the transaction as a mortgage loan when the borrower’s initial investment meets the criteria in paragraph 11 of Statement 66⁷ and the borrower’s payments of principal and interest on the loan are adequate to maintain a continuing investment in the property which meets the criteria in paragraph 12 of Statement 66.⁸

The financial statements of properties which will secure mortgage loans made or to be made from the proceeds of the offering which have the characteristics of real estate investments or joint ventures should be included as required by Rule 3–14 in the registration statement when such properties secure loans previously made, or have been identified as security for probable loans prior to effectiveness, and in filings

paragraph 12(c) of Statement 133 exempts a hybrid contract from bifurcation if a separate instrument with the same terms as the embedded equity kicker is not a derivative instrument subject to the requirements of Statement 133.

⁶ Expected residual profit is defined in Exhibit I to PB1 as the amount of profit, whether called interest or another name, such as equity kicker, above a reasonable amount of interest and fees expected to be earned by the “lender.”

⁷ Statement 66 establishes standards for the recognition of profit on real estate sales transactions. Paragraph 11 states that the buyer’s initial investment shall be adequate to demonstrate the buyer’s commitment to pay for the property and shall indicate a reasonable likelihood that the seller will collect the receivable. Guidance on minimum initial investments in various types of real estate is provided in paragraphs 53 and 54 of Statement 66.

⁸ Paragraph 12 of Statement 66 states that the buyer’s continuing investment in a real estate transaction shall not qualify unless the buyer is contractually required to pay each year on its total debt for the purchase price of the property an amount at least equal to the level annual payment that would be needed to pay that debt and interest on the unpaid balance over not more than (a) 20 years for debt for land and (b) the customary amortization term of a first mortgage loan by an independent established lending institution for other real estate.

made pursuant to the undertaking in Item 20D of Securities Act Industry Guide 5.

Rule 1–02(w) of Regulation S–X includes the conditions used in determining whether an acquisition is significant. The separate financial statements of an individual property should be provided when a property would meet the requirements for a significant subsidiary under this rule using the amount of the “loan” as a substitute for the “investment in the subsidiary” in computing the specified conditions. The combined financial statements of properties which are not individually significant should also be provided. However, the staff will not object if the combined financial statements of such properties are not included if none of the conditions specified in Rule 1–02(w), with respect to all such properties combined, exceeds 20% in the aggregate.

Under certain circumstances, information may also be required regarding operating properties underlying mortgage loans where the terms do not result in the lender having virtually the same risks and potential rewards as those of owners or joint venturers. Generally, the staff believes that, where investment risks exist due to substantial asset concentration, financial and other information should be included regarding operating properties underlying a mortgage loan that represents a significant amount of the registrant’s assets. Such presentation is consistent with Rule 3–13 of Regulation S–X and Rule 408 under the Securities Act of 1933.

Where the amount of a loan exceeds 20% of the amount in good faith expected to be raised in the offering, disclosures would be expected to consist of financial statements for the underlying operating properties for the periods contemplated by Rule 3–14. Further, where loans on related properties are made to a single person or group of affiliated persons which in the aggregate amount to more than 20% of the amount expected to be raised, the staff believes that such lending arrangements result in a sufficient concentration of assets so as to warrant the inclusion of financial and other information regarding the underlying properties.

Question 2: Will the financial statements of the mortgaged properties be required in filings made under the 1934 Act?

Interpretive Response: Rule 3–09 of Regulation S–X specifies the requirement for significant, as defined, investments in operating entities, the operations of which are not included in

the registrant’s consolidated financial statements.⁹ Accordingly, the staff believes that the financial statements of properties securing significant loans which have the characteristics of real estate investments or joint ventures should be included in subsequent filings as required by Rule 3–09. The materiality threshold for determining whether such an investment is significant is the same as set forth in paragraph (a) of that Rule.¹⁰

Likewise, the staff believes that filings made under the 1934 Act should include the same financial and other information relating to properties underlying any loans which are significant as discussed in the last paragraph of Question 1, except that in the determination of significance the 20% disclosure threshold should be measured using total assets. The staff believes that this presentation would be consistent with Rule 12b–20 under the Securities Exchange Act of 1934.

Question 3: The interpretive response to question 1 indicates that the staff believes that the borrower’s equity in an operating property is adequate to support accounting for the transaction as a mortgage loan when the borrower’s initial investment meets the criteria in paragraph 11 of Statement 66 and the borrower’s payments of principal and interest on the loan are adequate to maintain a continuing investment in the property which meets the criteria in paragraph 12 of Statement 66. Is it the staff’s view that meeting these criteria is the only way the borrower’s equity in the property is considered adequate to support accounting for the transaction as a mortgage loan?

Interpretive Response: No. It is the staff’s position that the determination of whether loan accounting is appropriate for these arrangements should be made by the registrant and its independent accountants based on the facts and circumstances of the individual arrangements, using the guidance

⁹ Rule 3–14 states that the financial statements of an acquired property should be furnished if the acquisition took place during the period for which the registrant’s income statements are required. Paragraph (b) of the Rule states that the information required by the Rule is not required to be included in a filing on Form 10–K. That exception is consistent with Item 8 of Form 10–K which excludes acquired company financial statements, which would otherwise be required by Rule 3–05 of Regulation S–X, from inclusion in filings on that Form. Those exceptions are based, in part, on the fact that acquired properties and acquired companies will generally be included in the registrant’s consolidated financial statements from the acquisition date.

¹⁰ Rule 3–09(a) states, in part, that “[i]f any of the conditions set forth in [Rule] 1–02(w), substituting 20 percent for 10 percent in the tests used therein to determine significant subsidiary, are met * * * separate financial statements * * * shall be filed.”