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September 12, 2016

Via Email [nasaacomments@Nasaa.org]

Mark Stewart, Counsel
NASAA Legal Department
750 First Street N.E., Suite 1140
Washington D.C. 20002

RE: NASAA's Proposed Amendment to the Statement of Policy Regarding Real Estate Investment Trusts

Dear Mr. Stewart:

I am writing on behalf of the Public Investors Arbitration Bar Association ("PIABA").[1] PIABA's members and their clients have a strong interest in the Model Rules and Statements of Policy issued by NASAA. As you know, our respective Associations often find themselves on the same side with respect to rules and regulations that govern the conduct of securities firms and their representatives. I thank NASAA for the opportunity to comment on NASAA's Proposed Amendment to the Statement of Policy Regarding Real Estate Investment Trusts ("Proposed Amendment"). However, in the interest of full disclosure, I should preface all that follows in this letter with the admission that PIABA does not believe that non-traded REITs should be sold to retail investors. Period. Having said that, PIABA commends NASAA on its effort to try to protect investors from the evils of highly risky, illiquid and opaque non-traded REITs since they do not seem to be going away.

INTRODUCTION

PIABA also wants to acknowledge that this is not the first time that NASAA has tried to implement investor protections by imposing a concentration limit or revising the definition of "net worth." PIABA is aware that NASAA's efforts in this regard were nearly uniformly shot down by the securities industry. Based upon PIABA's limited research into NASAA's history on these issues, just a sampling of a few of the nearly 90 comment letters that NASAA apparently received in at the of 2006 (when versions of some of the changes now in the Proposed Amendment were previously proposed) reflect what NASAA was (and now, is) up against. More specifically, it is clear that groups such

[1] As you know, PIABA is an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct.

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as the Securities Industry and Financial Markets Association ("SIFMA"), the Financial Services Institute ("FSI") and, not surprisingly, the National Association of Real Estate Investment Trusts, seemed to all take pages out of the same playbook when they touted the benefits of direct participation programs ("DPPs"') and insisted that the existing then-NASD rules regarding suitability of those products were sufficient to protect investors.[2] At least one of the commenters felt that the proposed language was not even appropriate for State securities regulators and that it was calling on them to … **regulate**.[3]

The three sample industry comment letters regarding NASAA's earlier proposal are ironic in that they almost seem offended that NASAA did not trust them to properly apply the existing FINRA rules for DPP sales and they felt that DPPs were such an important part of proper portfolio diversification that it would be unfair to keep a certain segment of the investing public from buying them (*e.g.*, those who could not afford to lose a significant amount of their net worth on DPPs). Little did NASAA, or any of us, know that the very people that NASAA's previous proposal was trying to protect would desperately need the protection just a few short years later.

In the "Background" section of NASAA's Notice to which PIABA's comment letter is responsive, NASAA states that it is "evaluating concentration limits for direct participation programs ('DPPs')", but that the "Concentration Limit Proposal" in the Notice is "the first in an anticipated series in this regulatory area" and "focuses on proposed amendments to the NASAA REIT Guidelines …" PIABA presumes that the "regulatory area" to which the Notice refers is the regulation of DPPs. PIABA supports additional efforts of NASAA to protect retail investors related to the sales of DPPs.

This letter addresses the substantive amendments included in the "red-line" version of the NASAA REIT Guidelines attached as Exhibit A to the Notice. From PIABA's perspective, there is still some problematic language in NASAA's Proposed Amendment relating to concentration limits. More specifically, PIABA finds the following elements of NASAA's Proposed Amendment troubling:

- Proposed Section IV.B.1. Concentration Limit – the proposed language establishes what amounts to a default concentration limit of ten percent (10%);

- Proposed Section IV.B.1. Concentration Limit – the proposed language only establishes a concentration limit for non-traded REITs (and not all DPPs);

[2] *See* September 9, 2016); https://www.financialservices.org/assets/0/56/288/3c6ceec2-5d8e-44d0-http://www.sifma.org/comment-letters/2007/sifma-submits-comments-to-several-state-regulators-on-the-nasaa-statement-of-policy-for-direct-participation-programs/ (last visited a232-f845c39e7881.pdf (last visited September 9, 2016);
https://www.reit.com/sites/default/files/media/Portals/0/Files/Nareit/htdocs/members/secureDocuments/NASAA%20submission%20BOG.pdf (last visited September 9, 2016).
[3] FSI's November 27, 2006 letter states that some of the provisions of the previous proposal "would harm IBDs "[Independent Broker Dealers"], affiliated financial advisors and their clients, by "[i]nterjecting the state regulator's own judgment into suitability decisions that are best left to an investor in consultation with his financial advisor."

- Proposed Section IV.B.1. Concentration Limit – the proposed language automatically carves out "Accredited Investors" under either the income or net worth standards in Regulation D, Rule 501;

- Proposed Section IV.B.2. Concentration Limit – the proposed definition of "liquid net worth" does not specifically exclude the value of investments in retirement accounts;

- Proposed Section IV.B.3. Concentration Limit – the proposed language regarding fiduciary accounts is generally confusing to the point that PIABA is not sure what it means and, thus, how to respond;

- Proposed Section IV.B.5. Concentration Limit – the proposed disclosure language does not create any safer standards or any additional liability for the sponsor or selling broker, but provides them with a potential "out" on liability if they made "every reasonable effort" to be sure the shares sold are within the concentration limit based on "information provided" by the investor regarding his "financial situation and investment objectives;" and

- Proposed Section IV.A.3. – Concentration Limit – the proposed language distinguishing adherence to the concentration limit from a suitability determination does not change long-existing obligations of brokers selling DPPs and its inclusion does not change such obligations.

Notwithstanding the foregoing, if non-traded REITs are going to continue to be sold by FINRA members to retail investors, PIABA does support the idea of a national, uniform minimum concentration limit for non-traded REITs. However, NASAA's proposed 10% limit is too high given the way in which the proposed concentration limit is to be calculated, what it will be applied to and what is to be included in an investor's "liquid net worth." PIABA's more specific comments/concerns about the Proposed Amendment are set forth at the end of this letter, but it makes sense to first consider the foundation upon which NASAA's Proposed Amendment (or its successor, if any) will be laid.

BACKGROUND

As you know, non-traded REITs are registered with the SEC and are subject to the Securities Act of 1933 and the Securities Exchange Act of 1934. As such, non-traded REITs must make public a prospectus of the securities for sale, as well as regular financial statements of the issuer and information about the issuer's management.[4] Still, problems persist with non-traded REITs (and other DPPs) because they are nothing more than illiquid, high commission versions of other, low-cost investment alternatives.[5] That being the case, regulators are often issuing guidance and reminders to FINRA member firms about sales practices related to non-traded REITs and other DPPs.

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[4] *See* http://www.slcg.com/pdf/workingpapers/Non%20Traded%20REITs%20White%20Paper.pdf ("A Primer on Non-Traded REITs and other Alternative Real Estate Investments") at page 2 (last visited September 7, 2016). Co-Author of this white paper, Craig McCann, Ph.D., CFA, is a Principal at Securities Litigation & Consulting Group ("SLCG") and has written many white papers and blogged about various securities, including non-traded REITs.
[5] *See, e.g.* http://www.slcg.com/pdf/workingpapers/Henderson%20Mallett%20McCann%20non-traded%20REITs.pdf ("An Empirical Analysis of Non-Traded REITs") (last visited September 7, 2016) and

Nonetheless, to date, regulations have been largely ineffective. According to Dr. McCann, non-traded REITs are not only riskier than traded REITs, but they also do not perform as well.[6] He compared the performance of more than 80 non-traded REITs to a diversified portfolio of traded REITs over 20 years and found the difference to be more than $45 billion. That is, investors in those non-traded REITs effectively gave up more than $45 billion they could have made in similar, traded investments. Dr. McCann refers to this as "wealth loss" and he attributes most of the underperformance to the high upfront fees and expenses of non-traded REITs – they can average over 13% of the total purchase price and most of that 13% goes to the broker that sold the product to the investor. As Dr. McCann illustrates, the problems with REITs are further exacerbated due to the structure of non-traded REITs, which is rife with conflicts of interest because sponsors of non-traded REITs often use affiliated firms as advisors and managers.[7]

Non-traded REITs, and other such non-traditional investments, are often referred to as Non-Conventional Investments ("NCIs") by FINRA and they have been particularly problematic for regulators for years. Before responding more fully with respect to the concerns raised above, it is worthwhile to look briefly at what FINRA has done to try to improve the odds that investors understand what non-traded REITs are (or aren't) and to increase the likelihood that the non-traded REITs that are sold to investors have been properly vetted before they are offered. It is not surprising that one of the primary purposes for recent regulatory guidance has been to emphasize and "remind" FINRA members of their obligation to ensure that the non-traded REITs sold to their customers are suitable for the customers. Additionally, FINRA has grappled with trying to increase the transparency of the pricing/stated value of non-traded REITs, which is particularly important for unsophisticated investors who do not understand that these complicated securities are unlike the stocks, bonds or mutual funds they hold in their investment accounts.

- ***NTM 03-71***

In November 2003. the National Association of Securities Dealers ("NASD," FINRA's predecessor) issued Notice to Members ("NTM") 03-71[8] regarding NCIs. The purpose of NTM 03-71 was to remind brokerage firms of their obligations when recommending NCIs to customers. According to NTM 03-71, brokerage firms are to take many steps **prior to** even recommending NCIs to customer.

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http://slcg.com/pdf/workingpapers/Fiduciary%20duty%20and%20Non-traded%20REITs.pdf ("Fiduciary Duty and Non-Traded REITs") (last visited September 7, 2016). Dr. McCann has also authored expert reports and testified many times in FINRA arbitration hearings about various securities, including non-traded REITs.

[6] *See* http://www.slcg.com/pdf/workingpapers/Henderson%20Mallett%20McCann%20non-traded%20REITs.pdf ("An Empirical Analysis of Non-Traded REITs") (last visited September 7, 2016).

[7] Statistics kept by the Financial Industry Regulatory Association ("FINRA") about customer arbitration claims against its members show that from 2012 through July 2016, out of **40** specific types of securities that can be involved in customer claims, the only securities in dispute more often than REITs were more traditional securities - common stocks, municipal bond funds, municipal bonds and mutual funds (the list also includes corporate bonds in 2015). Granted, the FINRA Claim Information Sheet does not specify non-traded (versus traded) REITs, but the experience of PIABA members has been that the REITs involved in our cases have primarily been non-traded REITs.

[8] *See* http://www.finra.org/sites/default/files/NoticeDocument/p003070.pdf (last visited September 7, 2016).

- ***NTM 05-26***

Still concerned about the growing number of complex and non-conventional products, in April of 2005, the then-NASD issued more guidance regarding such products in NTM 05-26.[9] NTM 05-26 was helpful in that it left very little to the imagination when it came to how firms should be dealing with new investment products. It provided that the vetting process of new products should consist of following firm policies and procedures and that those policies and procedures should result in obtaining answers to questions specified in NTM 05-26. NTM 05-26 also discussed "best practices" revealed in a survey of certain firms that create proprietary products and/or distribute third-party products. The "take-aways" are that firms' procedures should be mandatory, formal, thorough, detailed and that they may require some follow up even after a new product is officially approved. Of course, as NTM 05-26 notes at the end, "… [E]even the most elaborate procedures will not be effective unless they are rigorously implemented, something that ultimately depends on the firm's culture and level of commitment on the part of the firm's leadership."

- ***RN 15-02***

In October 2014, the U.S. Securities and Exchange Commission ("SEC") approved certain FINRA rule amendments in order to supposedly increase transparency for investors related to non-traded REITs. Those amendments are found in Regulatory Notice 15-02,[10] which modified then-NASD Rule 2340 regarding customer account statements and FINRA Rule 2310 regarding DPPs. The amendments went into effect on April 11, 2016.

RN 15-02 prohibits firms that want to participate in a public offering of a non-traded REIT from doing so unless the issuer has agreed to disclose in periodic filings a per-share estimated value that was developed in a manner that was designed to ensure its reliability. The two presumably reliable valuation methods specifically set forth in RN 15-02 are the "net investment method" and the "appraised value method."

Unfortunately, while transparency regarding the stated values of non-traded REITs is important, it does not change the fact that the non-traded REITs are generally not good for anyone but the broker, the sponsor/issuer and those affiliated with the them. Indeed, even though FINRA Rule 2340 now requires that non-traded REIT values be included in customer account statements, customers may still be faced with a disclosure that the stated value is not really what is says it is (*i.e.*, where a distribution includes return of capital or because the securities are not readily traded the price received in a sale may not be the value stated).

The grim reality is that most customers will never fully appreciate the uncertainty of determining a value for a security that is not traded on a national securities exchange regardless of how many ways the value is determined or how many disclosures about the value are given.

[9] *See* http://www.finra.org/sites/default/files/NoticeDocument/p013755.pdf (last visited September 7, 2016).
[10] *See* http://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-02.pdf (last visited September 7, 2016).

COMMENTS RELATED TO PROPOSED AMENDMENT

- *Proposed Section IV.B.1. Concentration Limit – the proposed language establishes what amounts to a default concentration limit of ten percent (10%);*

While PIABA generally supports NASAA's attempt to create a national, uniform concentration limit for non-traded REITS, it simply cannot condone a limit as high as ten percent (10%) in all situations. Moreover, a REIT may increase this limit if it determines (and the securities regulators agree) it would be appropriate. For many retail investors, ten percent (10%) of their net worth represents a substantial sum of money. To have the money invested in a highly risky, illiquid product is rarely appropriate. Further, investors may be invested in multiple DPPs, each one individually representing ten percent (10%) of the investor's net worth. This is simply too great an exposure for retail investors in these sorts of products.

- *Proposed Section IV.B.1. Concentration Limit – the proposed language only establishes a concentration limit for non-traded REITs (and not all DPPs);*

Although PIABA's understanding is that the Proposed Amendment is the first of a series, the current proposal presents the risk that investors could wind up with large portions of their net worth invested in non-traded REITs, as well as other DPPs with the same types of risks and similar lack of liquidity as non-traded REITs (*e.g.*, limited partnerships, private placements and the like). Certainly such a result is not intended, but as the Proposed Amendment is currently worded, it could actually be harmful to investors if they are allowed to be over-concentrated in DPPs.

- *Proposed Section IV.B.1. Concentration Limit – the proposed language automatically carves out "Accredited Investors" under either the income or net worth standards in Regulation D, Rule 501;*

PIABA does not support carving out "Accredited Investors" under Regulation D, Rule 501 from the protections the Proposed Amendment is intended to bestow. The income and net worth standards set forth in Regulation D have not been updated since 1982 and are woefully outdated. As a result, a much larger portion of the population is already captured under the definition of "Accredited Investor" than was originally intended. Additionally, just because an investor qualifies as an "Accredited Investor" under the artificially low income and net worth dollar amounts, does not necessarily mean that they have the financial resources to take on the risks typically associated with non-traded REITs. Further, investors who are otherwise "accredited" under Regulation D still may not be sophisticated enough with respect to investments to appreciate the significant risks and illiquidity of non-traded REITs and other DPPs. "Accredited Investors" should be provided with the same protections as other retail investors.

- *Proposed Section IV.B.2. Concentration Limit – the proposed definition of "liquid net worth" does not specifically exclude the value of investments in retirement accounts;*

If the Proposed Amendment is passed and implemented such that a national, uniform concentration limit goes into effect for non-traded REITs, then NASAA should go back to what it previously proposed regarding net worth calculations. PIABA is adamant that NASAA was right in its previous proposal when it excluded certain retirement

accounts and benefits from the net worth calculation. If broker/dealers are going to continue to be permitted to sell non-traded REITs to retail investors, the retirement accounts and benefits of those investors should be excluded from their "liquid net worth."

- *Proposed Section IV.B.3. Concentration Limit – the proposed language regarding fiduciary accounts is generally confusing to the point that PIABA is not sure what it means and, thus, how to respond;*

PIABA certainly means no disrespect to NASAA and those that clearly worked long and hard on the Proposed Amendment, but PIABA does not understand what the intended application of the proposed language in this section is. What is a "fiduciary account" in this instance and has that changed due to the Department of Labor's action on the Fiduciary Duty Rule? How, if at all, does the proposed language correlate or relate to an investor's other accounts (*i.e.*, "non-fiduciary accounts")? Are items included in the proposed liquid net worth and concentration limit calculations meant to be kept separate as between "fiduciary accounts" and "non-fiduciary accounts" or are they meant to be aggregated? For example, given the Proposed Amendment, if Joe Investor has 10 "non-fiduciary accounts" worth $100,000 each and is also the beneficiary of a single "fiduciary account" worth $1 million, what total dollar amount would be used for net worth/concentration limit purposes?

- *Proposed Section IV.B.5. Concentration Limit – the proposed disclosure language does not create any safer standards or any additional liability for the sponsor or selling broker, but provides them with a potential "out" on liability if they made "every reasonable effort" to be sure the shares sold are within the concentration limit based on "information provided" by the investor regarding his "financial situation and investment objectives."*

While PIABA appreciates that NASAA has spelled out the requirement that sponsors and those selling shares on behalf of the sponsors make every effort to determine that a purchase satisfies the concentration limit, the proposed language does not appear to provide any protection (additional or otherwise) to investors. When investors see this language in the prospectus, assuming they read and understand it, they may take it to mean that the sponsor or selling broker has exercised some special level of due diligence beyond what is already required of them by the rules. Such an understanding could result in the investor attributing legitimacy or suitability to the product that he otherwise would not have and that can be more dangerous than remaining silent on the subject of the duties of those selling these risky non-traded products. PIABA's view is that such a risk is not outweighed by any benefit to the investor and that the safer route would be to exclude the disclosure in its entirety.

- *Proposed Section IV.A.3. – Concentration Limit – the proposed language distinguishing adherence to the concentration limit from a suitability determination does not change long-existing obligations of brokers selling DPPs and its inclusion does not change such obligations.*

Again, while PIABA appreciates that NASAA has reminded those involved in the sale of non-traded REITs that adhering to a concentration limit does not satisfy other suitability rules, it should be recognized that many brokers have continued to erroneously use the REIT's own suitability guidelines and the "Accredited Investor" thresholds as a proxy for FINRA's required suitability analysis. Thus, the reality is that notwithstanding the proposed language in this section, brokers will likely also misuse the concentration limit in that manner. It is entirely unclear what purpose the inclusion of that "disclosure" language has *vis-a-vis* the investor. That being the case, it is PIABA's opinion is

that the risk of an investor misunderstanding the legal significance of the proposed "disclosure" language outweighs the benefit to the investor of including it such that the proposed language should be excluded.

CONCLUSION

Thank you for taking on the unenviable task of trying to add some protections to retail investors nationally who are being sold unsuitable non-traded REITs. If Congress and the other "powers that be" refuse to prohibit the sale of DPPs like non-traded REITs to retail investors, then the best PIABA can hope for is to increase protections available to retail investors related to the sale of those securities. It is PIABA's sincere hope that as many investor protections as possible will be included in the final amended version of NASAA's Statement of Policy Regarding Real Estate Investment Trusts.

PIABA thanks you for the opportunity to comment on the Proposed Amendment.

Very truly yours,

Marnie C. Lambert
PIABA EVP/President-Elect
Chair of NASAA Committee

cc: Michael Pieciak [*via* email only to Michael.Pieciak@vermont.gov]
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