

# CARDOZO LAW

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Mr. Mark Stewart  
Counsel  
NASAA Legal Department  
750 First Street, NE, Suite 1140  
Washington, DC 20002

Dear Mr. Stewart,

The Securities Arbitration Clinic at the Benjamin N. Cardozo School of Law (“the Clinic”) submits this letter in response to the North American Securities Administrators Association, Inc.’s (“NASAA”) proposed amendments to the Statement of Policy Regarding Real Estate Investment Trusts. Specifically, the Clinic is commenting on the NASAA proposal to add a uniform concentration limit of ten percent (10%) of an individual’s liquid net worth, which would be applicable to the individual’s aggregate investment in a REIT, its affiliates, and other non-traded REITs (“the Proposed Rule”). Liquid net worth is defined by the NASAA as cash, cash equivalents, and readily marketable securities. We are also commenting on the record maintenance and prospectus disclosure requirements for Sponsors.

In our practice, we primarily represent, on a *pro bono* basis, small investors, many of whom are elderly, have limited income, and/or otherwise have limited education and/or limited understanding of financial products and markets. We write on behalf of the investor population that fits within these categories.

Non-traded Real Estate Investment Trusts (REITs) are complex, and our client population often lacks sufficient knowledge of the risks to make meaningful choices about their investments. REITs are often marketed for their higher yields, but they also often present high risk. The SEC and FINRA have identified several risks associated with non-traded REITs,<sup>1</sup> many

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<sup>1</sup> See *Public Non-Traded REITs—Perform a Careful Review Before Investing*, FINRA, <http://www.finra.org/investors/alerts/public-non-traded-reits-careful-review>; *Investor Bulletin: Non-traded REITs*, SEC (Aug. 31, 2015), [https://www.sec.gov/oiea/investor-alerts-bulletins/ib\\_nontradedreits.html](https://www.sec.gov/oiea/investor-alerts-bulletins/ib_nontradedreits.html); *Investor Bulletin: Publicly Traded REITs*, SEC (Aug. 30, 2016), [https://www.sec.gov/oiea/investor-alerts-bulletins/ib\\_reits.html](https://www.sec.gov/oiea/investor-alerts-bulletins/ib_reits.html).

publicly traded and cannot be readily sold in a secondary market. Instead, investors have to wait until the non-traded REITs liquidate their assets or list their shares on an exchange. Second, although high dividend yields are attractive to investors, non-traded REITs use offering proceeds to pay out these distributions. Dividends are actually paid using the money of prior investors. This method of distribution reduces both the value of the shares and the cash to purchase other assets. Third, the lack of a market price from a publicly traded market creates difficulty in valuing the shares of non-traded REITs.<sup>2</sup> Share valuations may not be accurate or timely, and often investors may not be able to discern the value or performance of their investments. In contrast, publicly traded REITs have performance benchmarks and analysts coverage that help to inform investors.

In an empirical study by Henderson et al., researchers found that in non-traded REITs, approximately 56% of investors' losses were due to upfront fees and conflicts of interest.<sup>3</sup> They estimated that the overall magnitude of underperformance in these investments is over \$45 billion. Investors such as our clients pay high upfront fees representing as much as 15% of the offering price, which lowers the value and return on their investment. These upfront fees are used by Sponsors to pay brokerage commissions. Conflicts of interest may arise because non-traded REITs have external managers who may manage other companies that compete with the investor's REIT. The researchers found that the lack of effective monitoring by and accountability to REIT shareholders contributes to investment underperformance.

On a number of occasions, the Clinic has represented unsophisticated investors whose brokers have recommended and invested them in non-traded REITs when such investments were unsuitable for them. For example, in one instance, we represented a seasonal fitness instructor, a single woman in her 50s, who had a significant need for liquidity. Induced by the promise of high returns, the investor, who had no knowledge of the risks of REITs, at her broker's recommendation, invested 33% of her assets in a non-traded Timberland REIT. When she went to sell it a few months later, she finally learned of the illiquid nature of the investment, as well as the difficulty in valuing the investment. In another case, the Clinic represented a retired flight attendant in her 60s who was living on disability as a result of injuries to her arm and shoulder. She had very little savings and a need for liquidity because her monthly expenses slightly exceeded her disability income. Her broker recommended investment of 45% of her account in a non-tradable REIT, leaving her at great financial risk and without sufficient liquidity to meet her income needs. In yet another instance, 25% of the liquid assets of an 83-year old widow with no children was placed into a non-tradable REIT, and again, she did not understand how illiquid the

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<sup>2</sup> See *Public Non-Traded REITs—Perform a Careful Review Before Investing*, FINRA, <http://www.finra.org/investors/alerts/public-non-traded-reits-careful-review>; *Investor Bulletin: Non-traded REITs*, SEC (Aug. 31, 2015), [https://www.sec.gov/oiea/investor-alerts-bulletins/ib\\_nontradedreits.html](https://www.sec.gov/oiea/investor-alerts-bulletins/ib_nontradedreits.html); *Investor Bulletin: Publicly Traded REITs*, SEC (Aug. 30, 2016), [https://www.sec.gov/oiea/investor-alerts-bulletins/ib\\_reits.html](https://www.sec.gov/oiea/investor-alerts-bulletins/ib_reits.html).

<sup>3</sup> Brian Henderson et al., *An Empirical Analysis of Non-Traded REITs*, SLCG, <http://www.slcg.com/pdf/workingpapers/Henderson%20Mallett%20McCann%20non-traded%20REITs.pdf>.

investment was until she tried to sell it to meet unexpected medical expenses that were not covered by Medicare. While we believe that these recommendations were all arguably made in violation of the FINRA suitability rule,<sup>4</sup> because there is such a strong emphasis on high yields on non-traded REITs and because the non-traded REITs tend to carry high commissions, brokers may have recommended these products on those bases. Liquidity and risk tolerance are two major concerns when determining the suitability of non-traded REITs. The concentration limit will protect our client population from broker-dealers locking up a majority of their liquid net worth in illiquid non-traded REITs.

Although the instances discussed above are anecdotal, we believe they evidence the need for the Proposed Rule. Notably, a number of states have implemented a 10% concentration limit on non-traded REITs, including California, Iowa, Kansas, Kentucky, Maine, Massachusetts, Michigan, Missouri, Nebraska, New Jersey, New Mexico, North Dakota, Ohio, Oregon, Pennsylvania, and Tennessee.<sup>5</sup> We support a uniform rule consistent with this standard.

With respect to the Proposed Rule's application to Accredited Investors, we believe that while the current Proposed Rule excludes application to Accredited Investors, there may be instances when Accredited Investors need the same protections as non-accredited investors. Wealth or assets are not always a proxy for sophistication and understanding. Certainly, there are charitable organizations, including community centers and tribal authorities, who may receive a significant donation and therefore have millions of dollars in assets, but lack the expertise to determine their exposure to risk. Application of this rule to unsophisticated parties in any category would provide the best protection.

The Clinic supports the Proposed Rule for the Sponsor to maintain records of the information used to determine that an investment satisfies the concentration standard and to disclose in the final prospectus the Sponsor's responsibility to make reasonable efforts to meet the concentration standard. These proposed changes would reinforce brokers' suitability obligations and would preserve the record of whether a Sponsor can sufficiently demonstrate that at least non-accredited investors have limited exposure to a non-traded REIT. In sum, the high commissions paid by Sponsors may drive broker-dealers to over concentrate portfolios with non-traded REITs. The transparency and disclosure requirements will help ensure that small investors have limited exposure to the risks of these complex, often illiquid, and often high-fee REITs.

Accordingly, the Clinic supports the NASAA's proposed amendments to the Statement of Policy Regarding Real Estate Investment Trusts. We believe that a uniform 10% concentration

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<sup>4</sup> FINRA Rule 2111.

<sup>5</sup> Peter M. Fass and Derek A. Wittner, *Blue Sky Practice for Public and Private Direct Participation Offerings* § 2:2 (2015-16 ed.).

limit on non-traded REITs will likely help protect our client population from grave financial harm.

Respectfully submitted,

\_\_\_\_\_/s/\_\_\_\_\_  
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\_\_\_\_\_/s/\_\_\_\_\_  
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\_\_\_\_\_/s/\_\_\_\_\_  
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