FS INVESTMENTS™

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

Dear Chair Pieciak, Chair Heuerman, Ms. Coverman and Mr. Stewart,

FS Investments (formerly Franklin Square Capital Partners) thanks NASAA and its Corporation Finance Section Committee (the "Committee") for the opportunity to comment on the proposed amendment to the NASAA Statement of Policy Regarding Real Estate Investment Trusts (the "Amendment"). Founded in Philadelphia in 2007, FS Investments' mission is to enhance and better diversify mainstream investors' portfolios by combining strong investor protections and industry-leading best practices with access to asset classes, strategies and investment managers typically available only to institutions and wealthy individuals.

FS Investments appreciates the openness and inclusiveness NASAA has shown stakeholders throughout this rulemaking process. As the Committee is aware, FS Investments offered an alternate proposal that would have applied to all Direct Participation Programs ("DPP") and allowed for a higher concentration limit for those issuers that embrace greater transparency and enhanced investor protections. While we continue to believe in the merits of our earlier proposal, we understand the Committee's decision to limit the Amendment at this time to non-traded REITs. That said, we strongly support two critical revisions made to the Amendment from earlier versions of the concentration limit proposal. The first of these revisions narrowed the breadth of the proposed limit from 10% of an investor's liquid net worth in all DPP securities to 10% of an investor's liquid net worth in non-traded REIT securities. Without the flexibility afforded under our alternate proposal, we believe this revision more appropriately tailors the scope of the proposed REIT Guideline concentration limit to investments in non-traded REITs.

The second of these revisions expanded the scope of the proposed investor-based exemption from qualified purchasers to accredited investors. FS Investments welcomes this change for two reasons: (1) the $5 million in investments needed to qualify as a qualified purchaser is so high a bar as to render the exemption effectively meaningless, and (2) excluding accredited investors from this exemption, would likely have the unintended consequence of diverting accredited investors away from state-registered, public DPP programs into the unregulated private markets where state regulators have far less ability to protect these investors. FS Investments thanks NASAA for its thoughtfulness in identifying the potentially harmful implications of these provisions in prior drafts of the concentration limit proposal and applauds the related revisions that now appear in the Amendment.

FS Investments supports a uniform concentration limit.

FS Investments supports a uniform concentration limit. While we do not believe over-concentration is a widespread problem, we also do not deny that it sometimes occurs. Similarly, we acknowledge that, while rare, over-concentration can have significant adverse consequences on investors. For this reason, we support NASAA's pursuit of a uniform concentration limit. However, we are concerned that, if adopted as proposed, the application of the Amendment by individual regulators in fifty-four jurisdictions will be anything but uniform.

The first sentence of the 'Summary' section of the Amendment (page 2 of the proposing release) states, "The proposal would add a *uniform* concentration limit of ten percent (10%) of an individual's liquid net worth" (emphasis added). Similarly, in the August 18, 2015 cover letter to a prior discussion draft of the Amendment, the DPP Project Group stated that a goal of the proposal was "to create a more uniform concentration standard across jurisdictions." However, notwithstanding this express objective of achieving uniformity, certain operative language in the Amendment is inherently non-uniform. For example, Section IV.A.2 states, "REITS with greater investor risk shall have a restrictive concentration limit," and Section IV.B.1 states, "Unless the ADMINISTRATOR determines that the risks or other factors in IV.A associated with the REIT would require lower or higher standards, . . ."

These two provisions, together with the infinite list of factors an administrator may consider as a result of Section IV.A.2.n, grant unlimited discretion to an administrator to impose *any* concentration limit it may choose. Furthermore, an administrator so inclined may do so on the basis of any factor it may conceive (or no factor at all), and the impacted issuer may not even be afforded notice of the factors the administrator considered or the process it followed (if any) in reaching its determination. In this regard, the Amendment leaves ample room for arbitrary action by regulators that would leave issuers little recourse. This outcome is, in our view, irreconcilable with NASAA's stated objective to promote uniformity across jurisdictions. With this outcome, the Amendment would only serve to exacerbate the lack of uniformity inherent in current concentration limit practice by spreading the disunity from a handful of states to all of them. Instead of one prospectus page devoted to unique state suitability standards, there could be (and likely would be) many more.

The concern identified above is not merely academic – the Amendment would add at Section IV.B.1 a clause that has been arbitrarily applied to FS Investments funds in the past. That clause, currently found at Section III.A.2 of the existing REIT Guidelines, reads "*Unless the ADMINISTRATOR determines that the risks or other factors in IV.A associated with the REIT would require lower or higher standards.*" It has been our experience that certain states routinely disregard the factors and procedures outlined in Section III.A of the current REIT Guidelines in raising the minimum income and net worth standards of Section III.B, usually without willingness to consider factors advanced by the issuer, including those enumerated in

Section III.A.2 of the Guidelines, or differences among issuers to which the standard is applied, such as the investor protections and transparency inherent in the issuer's offering that are absent from another issuer with a similar offering. We have little doubt that some states would likewise disregard the factors and procedures proposed at Section IV.A of the Amendment in order to arbitrarily tighten their concentration limit beyond that proposed at Section IV.B.1. We offer this observation as a concrete example of how Section IV.B.1 of the Amendment will invite non-uniformity in the application of NASAA's uniform concentration limit.

To prevent this outcome and better achieve NASAA's stated objective of promoting uniform application of its proposed concentration limit, we recommend two revisions to the Amendment:

> **Section IV.A.2.** The SPONSOR shall propose a minimum concentration limit which is reasonable given the type of REIT and the risks associated with the purchase of SHARES. ~~REITS with greater investor risk shall have a restrictive concentration limit.~~ The ADMINISTRATOR shall evaluate the standards and any exclusion proposed by the SPONSOR when the REIT'S application for registration is reviewed.

and

> **Section IV.B.1.** Unless the ADMINISTRATOR determines that the risks or other factors in IV.A. associated with the REIT would require lower ~~or higher~~ standards, a PERSON's aggregate investment in the REIT, its AFFILIATES, and other non-traded REITS shall not exceed 10% of the PERSON's liquid net worth.

These changes would clearly establish the default concentration limit provided in Section IV.B.1 as the upper-bound, the most restrictive concentration limit a state may impose in compliance with the guidelines, while preserving discretion to ease the concentration limit for good cause shown.[1] We believe this simple change would greatly enhance the uniform application of the concentration limit by removing the discretion of an individual state to substitute its judgment for the collective wisdom of NASAA in arbitrarily imposing a more restrictive standard of its own design. Moreover, this change would not reduce the effectiveness of the Amendment or otherwise frustrate its purpose as the limit proposed, 10% of an investor's liquid net worth in all non-traded REITs, is already quite restrictive.[2] Further tightening of the concentration limit applied to an offering, such as the 10% liquid-net-worth cap applied to all DPPs that we see in some states today, amounts to a *de facto* bar to that

[1] There is a significant ambiguity in the Amendment's use of the words "lower or higher standards" that could result in confusion. Depending on the reader, both 5% and 15% could be reasonably understood to be a "higher standard." In the 5% reading, 5% could be interpreted as a higher standard because a 5% concentration limit is more restrictive than a 10% concentration limit. In the 15% reading, 15% could be interpreted as a higher standard because 15% is numerically higher than 10%, despite being a less restrictive concentration limit. We recommend changing "lower" to "less restrictive" and deleting "or higher" to resolve this ambiguity.

[2] In practical terms, the maximum aggregate investment this standard would allow in all non-traded REITs is 10% of a person's current holdings in cash and exchange-listed securities.

issuer selling securities in the jurisdiction, which we believe is inconsistent with the intent of the NASAA guidelines and all state securities acts.

The success of NASAA's Regulation A Coordinated Review Program lies in its uniform application. We understand the extraordinary lengths NASAA went to in order to ensure nationwide uniformity with respect to the review of Regulation A offerings, and we appreciate the reluctance states felt toward relinquishing individual discretion so that the coordinated review protocol could work. We encourage NASAA to build on the formula that made the Regulation A Coordinated Review Program successful and to apply the same commitment to uniformity to the concentration limit proposal.

NASAA should limit the inclusion of "affiliates" in the concentration limit to "non-traded affiliates."

FS Investments understands that the concentration standard set out at Section IV.B.1 of the Amendment, "a PERSON'S aggregate investment in the REIT, its AFFILIATES, and other non-traded REITS," is intended to address three distinct forms of over-concentration risk. The first clause, "investment in the REIT," and the third, "and other non-traded REITS," are representative of the widely agreed upon investing principle of portfolio diversification. However, the second clause, affiliates of the REIT, is more nuanced. Certainly, there are risks attendant to program sponsors that could negatively impact each program in a sponsor's product line, such as general business risk, reputation risk, and legal and regulatory risk. High investor concentration in programs of a single sponsor, even if diversified by asset class and industry, could, in certain circumstances such as an accounting fraud, cause real investor harm. To this extent, FS Investments agrees with the policy underlying the inclusion of "affiliates" in the Amendment. However, the definition of "affiliate" at Section I.B.5 of the REIT Guidelines is extremely broad.

In 2006, Fidelity Investments ("Fidelity") filed with the states an application to register its first non-traded REIT, Fidelity Property Income Trust ("Fidelity REIT"). Fidelity REIT was extremely innovative in that it would have charged investors no selling commissions or other underwriting compensation of any kind, provided for none of the transaction-based compensation common among non-traded REITs such as acquisition and disposition fees, and proposed to charge investors only a 1.1% annual advisory fee plus reimbursement for ordinary expenses.[3] Ultimately, Fidelity withdrew the offering due to unfavorable market conditions and Fidelity REIT never launched, but had it come to market, Fidelity REIT would have been the lowest cost non-traded REIT available by a wide margin.

For the purpose of the Amendment, assume that Fidelity REIT had come to market. Fidelity is a leading sponsor of low-cost investment products, including mutual funds and exchange-traded-funds ("ETF"). Today, Fidelity is the fourth largest asset manager in the world[4] with over $2.1 trillion in assets under management.[5] Many of Fidelity's funds are the lowest cost

[3] Fidelity REIT prospectus dated December 14, 2007, cover page and pages 7-8, available: https://www.sec.gov/Archives/edgar/data/1368075/000119312507265800/ds11a.htm#tx30936_6.
[4] Investment & Pensions Europe. "Top 400 Asset Managers 2016." June 2016. Available: https://www.ipe.com/reports/special-reports/top-400-asset-managers/top-400-asset-managers-2016-global-assets-now-563trn/10013542.fullarticle.
[5] Fidelity Website. "Fidelity by the Numbers: Asset Management." December 2015. Available: https://www.fidelity.com/about-fidelity/fidelity-by-numbers/asset-management.

option in their market segment and routinely beat rival Vanguard funds on price.[6] Under the REIT Guideline definition of "affiliate," each Fidelity mutual fund and ETF may be considered an affiliate of Fidelity REIT for the purpose of determining how much an investor may invest in Fidelity REIT under the proposed concentration limit. If 10% of an investor's liquid net worth was already invested in Fidelity mutual funds and ETFs, that investor would be precluded from investing in the Fidelity REIT, even if the investor owned no other non-traded REIT securities.[7] In this scenario, the proposed concentration limit would force the investor to avoid the no-load, low cost Fidelity REIT and potentially instead buy a full-load, higher cost non-traded REIT.

This outcome can be avoided with a simple addition to the Amendment:

> **Section IV.B.1.** . . . a PERSON's aggregate investment in the REIT, its non-traded AFFILIATES, and other non-traded REITS shall not exceed 10% of the PERSON's liquid net worth.

While Fidelity provides a historical example, recent trends indicate that this may become an increasingly common scenario.[8] The entrance of firms like Fidelity and other institutional-quality asset managers into the non-traded REIT market should be welcomed by regulators, as the presence of these firms will likely exert pressure on existing non-traded REIT sponsors to improve deal terms and industry practices for the benefit of investors.[9]

Furthermore, this change would make the limit's second clause consistent with its third clause, in which only other non-traded REITs are included instead of all REITs. We believe this change is desirable for three reasons. First, excluding exchange-traded affiliates from the concentration calculation would avoid unintended consequences on portfolio construction as illustrated by the Fidelity REIT example. Second, the conceptual justification for the concentration limit lies in the need to prevent investors from tying up too much of their savings in illiquid investments; investors do not need this protection with respect to their liquid holdings and this assertion should be as true for listed affiliates as it is for listed REITs. Third, by including exchange-traded affiliates in the concentration calculation, NASAA would create disincentives for sponsors to innovate new products and product features that may benefit investors. For example, it may discourage traditional non-traded REIT sponsors from diversifying their product lines into liquid investment vehicles, and it may discourage mainstream asset managers such as Fidelity from diversifying into non-traded funds, which may improve the overall DPP market. Finally, making the change suggested above would continue to protect investors from the risk of over-concentration in affiliated illiquid programs.

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[6] Fidelity Website. "Fidelity's index funds beat comparable Vanguard funds on expenses." July 1, 2016. Available: https://www.fidelity.com/mutual-funds/investing-ideas/index-funds.

[7] It is not unusual for investors to have a significant amount of their liquid net worth invested across a variety of mutual funds from the same fund sponsors, such as Fidelity and Vanguard. Many 401(k) plans offer a diversified menu of funds from the same fund family.

[8] FundFire. "Blackstone REIT Push Cuts Path for Alts Peers." July 31, 2016. Available: http://www.fundfire.com/c/1442133/165503/blackstone_reit_push_cuts_path_alts_peers.

[9] Bloomberg. "Blackstone Enters Nontraded REIT Market With New Fund." July 10, 2016. Available: http://www.bloomberg.com/news/articles/2016-08-10/blackstone-enters-nontraded-reit-market-with-a-5-billion-fund, ("They're going to make the business better." Blackstone's entry "will force other players in the space to raise their game.").

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FS Investments sincerely thanks NASAA and the Corporate Finance Section Committee for the opportunity to comment on its proposed REIT Guideline concentration limit, as well as for the openness and responsiveness of NASAA, and particularly the DPP Project Group, to stakeholders throughout the rulemaking process. We hope our comments add to a respectful and constructive dialogue and help NASAA to adopt a final guideline that strikes an appropriate balance. We encourage you to contact Seth Hertlein at 202-350-9877 or seth.hertlein@fsinvestments.com to discuss in greater detail any aspect of this letter or the Amendment.

Sincerely,

Michael F. Gerber Executive Vice President	Stephen S. Sypherd General Counsel	Seth A. Hertlein Senior Counsel

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