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Securities Arbitration Clinic

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VIA Email to nasaacomments@nasaa.org
Mr. Mark Stewart
Counsel
NASAA
750 First Street, NE, Suite 1140
Washington, DC 20002

Re: Proposed Amendments to the NASAA Statement of Policy regarding Real Estate Investment Trusts

Dear Mr. Stewart,

The Securities Arbitration Clinic at St. John's University School of Law is very pleased to accept this opportunity to comment on the proposed amendments to the NASAA Statement of Policy Regarding Real Estate Investment Trusts ("REIT Guidelines"). The Clinic supports the proposed rule, which seeks to adopt a national concentration limit for non-traded REITs at ten percent of an investor's liquid net worth. This proposed rule change is especially important to small investors, as the market for non-traded REITs usually suffers from liquidity issues and these issues have a much larger deleterious effect on those small investors.

The Securities Arbitration Clinic is a not-for-profit organization staffed by second and third year law students that provides free legal representation to public investors. Our clients are otherwise unable to obtain legal representation in their securities disputes primarily due to the small dollar amount of the claim. If the Clinic did not represent them, our clients would likely be forced to proceed *pro se* or not pursue their claims at all. Our clients are generally of modest means and do not have the financial capacity to withstand even small losses of their net worth. In addition to representing aggrieved investors, the Clinic is committed to investor protection. Accordingly, we have a strong interest in rules that affect investors.

Non-traded REITs are registered securities that are not listed on national exchanges. As a consequence, non-traded REITs are generally unsuitable for small, unsophisticated investors for

a variety reasons. First, non-traded REITs rely on down-the-road "liquidity events," whereby the non-traded REIT is either listed on a national security exchange or acquired by another exchange-traded REIT. Prior to this event, a period which lasts several years,[1] shares in a non-traded REIT are largely illiquid. In some instances, investors are able to redeem their shares on a periodic basis, but only after paying significant fees.

Second, the lack of a secondary market for the sale of shares of non-traded REITs creates transparency and valuation issues. Investors are unable to rely on readily-available market quotations for the value of their non-traded REIT shares. Rather, investors must rely on annual valuations conducted by the REIT's sponsors. Although this valuation process is regulated, the inherent conflict of interest is troublesome.

For a vast majority of small investors, particularly those in retirement, such illiquid investments are unsuitable *per se*. These investors often rely on the ability to liquidate their investments over time to augment their income or to cover unexpected expenses. The inability to liquidate shares of a non-traded REIT without considerable early redemption fees if at all prior to a liquidity event makes these investments unsuitable for the typical small investor. In addition, the typical small investor has neither the information nor the wherewithal to accurately evaluate their investment on an ongoing basis.

Moreover, non-traded REITs are intrinsically worse investments than their exchange-traded counterparts. The fees brokers charge on the sale of the non-traded REIT shares can often reach fifteen percent.[2] These front-end loads represent a massive barrier that small investors must overcome in order to see their investments make positive returns. By contrast, exchange-traded REITs, which as their name suggests, can be purchased on a national security exchange where investors are charged significantly less brokerage commissions. Such a jarring disparity between the front-end fees associated with non-traded REITs and exchange-traded REITs has led some commentators to suggest that advising a client to purchase a non-traded REIT would constitute a breach of fiduciary duty if such a duty existed between a broker and her client.[3]

As currently constituted, the NASAA's REIT Guidelines do not adequately protect investors. The proposed concentration limit allows an issuer or broker to invest up to ten percent (10%) of an investor's net worth into non-traded REITs. This protection does not extend to "Accredited Investors." It should be noted that the standards qualifying an investor as "accredited" have not been updated since 1982. Accordingly, they capture individuals who do not have the financial ability to withstand the risks associated with investing in non-traded REITS nor the financial sophistication to understand these products. By carving out investors who are "accredited" under the current standards, the proposed rule will limit its protection unnecessarily.

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[1] FINANCIAL INDUSTRY REGULATORY AUTHORITY, PUBLIC NON-TRADED REITS—PERFORM A CAREFUL REVIEW BEFORE INVESTING, (April 27, 2016), http://www.finra.org/investors/alerts/public-non-traded-reits-careful-review.

[2] *Id.*

[3] Craig McCann, *Fiduciary Duty and Non-Traded REITs*, INVESTMENTS AND WEALTH MONITOR, July/Aug. 2015, at 39, *available at* http://slcg.com/pdf/workingpapers/Fiduciary%20duty%20and%20Non-traded%20REITs.pdf.

Further, the proposed rule states that adherence to the concentration limit does not satisfy an issuer's or broker's other suitability obligations. The suitability requirements impose default income and net worth standards for investors in non-traded REITs. While these standards are flexible depending on the level of risk for a given non-traded REIT, they are ineffective protection for the still relatively small investors who fall within this minimum threshold. The Clinic has handled multiple cases in which relatively small investors were, at the advice of their brokers, heavily invested in non-traded REITs despite stated investment objectives. Each of the investors qualified under the REIT's suitability guidelines, however, the broker failed to satisfy the FINRA suitability obligation. Brokers have used the REITs own suitability requirements as determinative of the overall suitability of the product for investors, regardless of the investor's individual financial situation or needs. It is likely that the concentration limit will be used in a similar manner – meaning that it will be deemed suitable for an investor to have up to 10% of his or her net worth invested in non-traded REITs because that is what the rule permits.

The non-traded REIT market has long suffered from a lack of transparency. The products are complex and difficult for the average investor to truly comprehend. Most investors do not appreciate the risks associated with investing in such a product. Unfortunately, despite the risk associated with these complex, highly illiquid products, over the years they have been heavily marketed to small investors, in part because of the high fees earned by the brokerage industry. While it is important that investors be afforded greater protections, and we support NASAA's proposed amendments to the REIT Guidelines, we believe there is more that can be done.

We appreciate the ability to comment on these very important changes. Thank you for your consideration in this matter.

Sincerely,

/s/

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Director

cc: Michael Pieciak, Chair of the Corporation Finance Section (michael.pieciak@vermont.gov
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