ALTERNATIVE & DIRECT INVESTMENT SECURITIES ASSOCIATION
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September 12, 2022

NASAA Corporation Finance Section
Ms. Andrea Seidt, Section Chair
Mr. Mark Heuerman, Project Group Chair
North American Securities Administrators Association, Inc. (NASAA)
750 First Street, N.E., Suite 1140
Washington, D.C. 20002

Via electronic submission to NASAAComments@nasaa.org, Andrea.Seidt@com.ohio.gov, and Mark.Heuerman@com.ohio.gov

Dear Commissioner Seidt and Mr. Heuerman:

The Alternative and Direct Investment Securities Association (ADISA),[1] is writing to provide its comments on certain revisions to the North American Securities Administrators Association, Inc.'s ("NASAA") Statement of Policy Regarding Real Estate Investment Trusts (the "REIT Guidelines"), proposed by NASAA's Corporation Finance Section ("Section") and the Direct Participation Programs Project Group ("Project Group"). The Section's purpose in making these proposals (collectively, the "Proposal") is to "keep NASAA Statements of Policy current and to enhance retail investor protections surrounding the offer and sale of non-traded real estate investment trusts ("REITs") to retail investors."[2]

ADISA members play an important role in bringing non-correlating, diversifying investments to a significant part of the investing population. Based on its review of the Proposal, ADISA believes that the Section should engage in additional dialogue and review information that ADISA is providing herein and will provide in the future, which information we believe offers differing perspectives on and, in some cases, a counternarrative to that relied upon by the Section in drafting the Proposal. We believe that, under the circumstances, the Section should take the time to fully assess this additional information, consider the alternative perspectives offered by such information and either defer or revise the Proposal prior to

[1]ADISA is the largest association of the retail direct investment industry in the United States. ADISA has approximately 4,500 members who employ over 220,000 investment professionals, together serving the interests of more than 2 million investors throughout the country. Direct and alternative investment programs serve a critical need in the creation and ongoing management of diversified investment portfolios.

[2] In this regard, however, the statement accompanying the Proposal (the "Statement") notes that, if adopted, these revisions have the potential to influence updates to other sets of guidelines that are under development, including the Omnibus Guidelines as well as guidelines for Asset-Backed Securities, Commodity Pools, Equipment Leasing, Mortgage Programs and Real Estate Programs (other than REITs). According to the Project Group, moreover, these updates will also permit the NASAA Business Organizations and Accounting Project Group to move forward with its proposal for inaugural guidelines applicable to business development companies.

putting its elements to NASAA members for their consideration. To that end, we believe that the Section should put the Proposal on hold while it conducts a detailed review of this information.

Discussion

A. Proposed Guideline Changes:

The Proposal is made up of four principal proposed revisions to the REIT Guidelines. Each of these proposed revisions is discussed in the Statement and is summarized below.

1. Update to the conduct standards for brokers selling non-traded REITs

The Section's first recommended revision would formally incorporate the new conduct standards found in the Securities & Exchange Commission's ("SEC") Regulation Best Interest ("Reg BI"), as well as other conduct standards adopted by the NASAA jurisdictions, so as to make them applicable to brokers recommending non-traded REITs. All offering documents of non-traded REITs have a suitability section that governs the standard of conduct that applies to persons selling or recommending the program's shares. The SEC adopted Reg BI in 2019 and it became effective June 30, 2020.

2. Upward adjustment to the net income and net worth financial figures

The Section is recommending an update to the net income and net worth figures used to determine suitability to adjust them for inflation. The Statement notes that the current figures have not been updated since May 7, 2007. As proposed, purchasers would have to have a minimum annual gross income of $95,000 and a minimum net worth of $95,000 or (b) a minimum net worth of $340,000. State administrators would retain their current authority under the Guidelines to require higher or lower numbers.

3. New standardized concentration limit

The Section is recommending the addition of a specific concentration limit within the REIT Guidelines that would set a ceiling equal to 10% of a purchaser's liquid net worth,[3] which limit would include the interest in the REIT being acquired plus interests in programs managed by "affiliates" and other non-traded direct participation programs (or "DPPs).[4] The Section notes that "a growing number of state securities regulators have independently imposed limits impacting the maximum amount a retail investor may invest in non-traded REITs offered in their jurisdictions," and proposes to inject "greater uniformity amongst the membership in this area."[5]

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[3] According to the Statement, "liquid net worth" would be defined as that component of an investor's net worth that consists of cash, cash equivalents, and marketable securities.

[4] According to the Statement, this approach was chosen "based on the observation that liquidity is restricted in all programs; high fees and expenses, conflicts, and lack of historical operations also predominate these offerings." In addition, the Statement notes that "as sponsors of non- traded REITs also sponsor business development companies, the proposed limit would cover those sales based on the restriction respecting affiliates and other non-traded direct participation programs."

[5] The Statement notes that "at least 20 different jurisdictions have imposed a concentration limit of some form on [non-traded REITs], some selectively on a case-by-case basis and others across the board: Alabama, California, Idaho, Iowa, Kansas, Kentucky, Maine, Massachusetts, Missouri, Nebraska, New Jersey, New Mexico, North Dakota, Ohio, Oregon, Pennsylvania, Puerto Rico, Tennessee, Texas and Vermont."

4. New prohibition against using gross offering proceeds to make distributions.

The Section's fourth and final proposed revision to the Guidelines concerns a product feature whereby REIT sponsors reserve the right to use investor proceeds from an offering to fund regular cash distributions. The Statement notes that investors "might not understand that this feature means that some of their money is not being invested in income-producing real estate, but rather is being used to pay distributions to investors." The Statement further provides that such a feature is an inefficient use of investor capital and has the potential to confuse and mislead retail investors.

B. NASAA's Rationale for Proposed Changes:

The Statement provides explicit sources for the recommendations it is making regarding proposed changes to the Guidelines. The rationales listed in the Statement consist of both specific as well as more general factors underlying or contributing to the proposed changes.[6]

1. Protection for Elderly Investors

In support of the Proposal, the Section asserts that REITs are heavily marketed to elderly investors, which it suggests are "not always a great match due to the liquidity restrictions inherent in these products." The Statement cites a number of arbitration as well as enforcement decisions involving elderly investors and directs the reader to several articles, etc., in financial publications to the effect that elderly and retired investors are not or may not be good candidates for such programs.[7] As the Section sees it, during the pandemic the liquidity risks inherent in these products materialized to the detriment of many investors. The redemption programs utilized by a number of issuers did not, in the Section's view, solve the issue: by its own count, the redemption programs for at least 18 direct participation programs (including three NAV REITs) were either suspended during the pandemic or amended in that timeframe to restrict investor withdrawals.

2. Excessive Cost and Complexity:

The Section notes that non-traded REIT offering documents are lengthy, complex, and contain terms that may be difficult for the average investor to understand.[8] The Statement also asserts that non-traded REITs are "costly" and include lucrative front and back-end expenses that entice brokers to sell these products to customers. The NASAA-produced report cited in the Statement asserts that firms recommending non-traded REITs "had the highest concentration of harmful compensation conflicts of any of the complex, costly, risky products that were recommended by firms examined in the state initiative post-Reg BI."

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[6] It should be noted that all four elements of the Proposal rely on other investor protection considerations as well.

[7] The articles cited in the Statement include one by Eleanor Laise, entitled, "Retirees, Don't Get Stranded Hunting Returns: Some Older Investors Are Turning to Unregistered Securities and Other Alternative Investment Risks," published in Kiplinger (Dec. 13, 2019); and another by Robert Stepelman entitled, "The Rational Investor: Don't Let Current Volatility Scare You into Non-Traded REITs," published on June 13, 2022.

[8] The Statement notes, for example, that a non-traded REIT prospectus is often close to 300 pages, not including organizational documents, supplements, financial statements and subscription agreements.

3. Lack of Updated Policies and Procedures:

The Section cites a recent NASAA report,[9] which indicated that many broker-dealer firms did not materially change their policies, procedures, or practices regarding the sale of non-traded REITs or other complex, costly, and risky products to retail investors since the adoption of Reg BI "notwithstanding the enhanced care, disclosure, and conflict of interest obligations mandated by the rule." This purported failure to amend policies to comply with Reg BI is seen by the Section as evidence that Reg BI did not materially alter the framework under which firms recommend non-traded REITs and other direct participation programs to their clients.

4. Investment Risks:

The Statement asserts that REIT offerings have significant risks, as disclosed in bullet points on the cover page of the prospectus, summary section, and in the risk factors section, and adds that non-traded REITs are a significant source of customer complaints.[10] The Statement adds that the sponsor community has generated various criminal enforcement actions over the years, including four federal fraud convictions in 2022 involving a Texas fund complex known as United Development Fund.

5. Poor Performance:

The Statement cites recent studies by the Securities Litigation & Consulting Group, which examined the performance of 140 non-traded REITs from June 1990 to December 2019 against the performance of traded REITs, as support for the notion that non-traded REITs have underperformed traded REITs. According to the Statement, the studies in question found that investors in non-traded REITs underperformed investors in traded REITs by approximately $75 billion.[11] The Statement also asserts that, since the DOL rule was vacated and Reg BI was adopted and implemented, there has been no attendant decrease in REIT customer complaints.

6. No Carve Out for Accredited Investors:

The Proposal does not include a carve-out for "accredited investors." According to the Statement, NASAA has repeatedly urged the SEC to make inflationary adjustments to that definition, without success. As provided in the Statement, many elderly citizens qualify as accredited investors based simply on their accumulated retirement savings. In the eyes of the Section, this is a critical class of investors that should be protected and providing a carve out for those who meet the accredited investor standard will not ensure that only sophisticated and experienced investors will qualify for such a carve out.

C. Statement of ADISA in Relation to the Proposal

NASAA's Proposal, as explicated in the Statement, relies upon a wide range of expressed concerns, concerns that we believe can be addressed in ways that are more narrowly tailored or in ways

[9] NASAA Reg BI Phase IIA Report (Nov. 2021), https://www.nasaa.org/wpcontent/uploads/2021/11/NASAA-Reg-BI-Phase-II-A-Report-November-2021_FINAL.pdf

[10] REITs had the second most arbitrations filed in the product type of customer complaints according to FINRA for 2021 and led all types of investments for 2020. FINRA Top 15 Controversy Types.

[11] See Joshua Mallett and Craig McCann, Further on the Returns to Non-Traded REITs, The Journal of Wealth Management Winter 2021, 24 (3) 113-127; DOI: https://doi.org/10.3905/jwm.2021.1.153

that operate differently than what has been proposed. We have set forth a number of key points from the NASAA Statement below along with alternative solutions or approaches that would incorporate a full understanding of the data and associated facts.

1. <u>Concern for Elderly Investors</u>

There is a pronounced concern threaded throughout the Statement that elderly investors are significant purchasers of securities issued by non-traded REITs (and other DPPs), and that the recommendations and subsequent purchases of such programs may, in many cases, be inappropriate. In particular, the Statement cites several enforcement and arbitration matters in which elderly investors acquired interests in non-traded REITs following recommendations by financial advisors which turned out to be less than fully suitable (or even wholly unsuitable) for such investors. These matters are used by the Section to support various aspects of the Proposal, including: (i) the applicable conduct standard; and (ii) the concentration limit.

ADISA and its members are fully supportive of legal and regulatory efforts to prevent and prosecute those that commit fraud, falsification of facts, or similar acts that inflict harm upon elderly, often defenseless investors. Such individuals should rightfully be held accountable.

A number of the matters cited involved older investors and the facts of many of such cases pointed to a lack of suitability. Other cases involved fraud and other acts that involved far more than concentration and/or liquidity issues.

ADISA does not believe that it is wholly fair, however, to assert that these actions (or decisions) are determinative of the question of whether non-traded REITs are ever suitable for older investors. As discussed below, non-traded REITs and other alternative investments have returns that are not correlated to the public markets and can provide important diversification benefits to investors of all stripes – e.g., young investors, older investors, those investors with large accumulations of wealth and those whose savings balances are smaller.

More importantly, a number of the matters cited in the Statement involved falsification of investor qualifications, as well as intentional or mistaken judgments regarding the investment horizons and risk tolerance of the investors involved. ADISA and its members believe that securities issued by non-traded REITs have to be well understood and recommended appropriately to any investor that is looking at making such an investment, including but not limited to, older investors. It is quite a leap from protecting elderly investors from advisers (including family members) who do not necessarily make appropriate recommendations, to the notion that elderly investors are targeted by advisers seeking to recommend non-traded REITs without regard to (or despite) their lack of liquidity. Lack of liquidity is a significant feature of these non-correlated products – but it is not necessarily a negative one, particularly in the case of older investors.

In general, elderly investors have a shorter time horizon for investing and a meaningful need for liquidity to support their spending. That does not mean, however, that non-traded REITs are necessarily poor choices for these investors. Based on their actual age, risk tolerance, income needs, wealth and other factors, elderly clients may, in fact, be appropriate purchasers of non-traded REITs. As discussed below, non-traded securities can provide important benefits, both in terms of returns as well as diversification.[12] Older investors typically are hoping to obtain (or maintain) yields while reducing the volatility of their investment portfolios. They typically lack the ability to wait out periods of lower market prices, as their investment horizons and their timetables are, on the whole, shorter. Non-traded REITs – and alternative

[12] Investors pay a price for liquidity, typically more than 1.4% (Whitman, K. "The Hidden Cost of Liquidity How Alternatives Can Reward Long-Term Investors" Alternative Investment Quarterly, January 2014).

investments in general – can assist in lowering volatility and lessen exposure of older investors to public markets.

ADISA is not suggesting that diversification by itself is a basis for recommending a non-traded REIT, business development company ("BDC") or other DPP; many such programs also produce an income stream.[13] What is important is the care taken by the selling firms regarding these individuals and their understanding of the factors that go into an assessment of their suitability for a given client – while age and liquidity are important, these factors are not inherent indicia of unsuitability. The Section's focus on illiquidity in the context of older investors, to our thinking, creates a direct line between age and liquidity, where older investors are seen as being inherently disadvantaged by illiquidity. This may be the case for certain investors – e.g., those with lower balances, higher expenses, or both – but does not and will not hold for all older investors. The simple fact that an investor is elderly (or no longer in the prime of their youth) does not mean that they should only own liquid assets. Illiquid assets provide important benefits and, if properly understood, are an important and helpful part of many older investors' portfolios. Associating investments in illiquid or only partially liquid assets with a violation of the applicable standard of care ignores those benefits and assumes that investors have (or can have) no tolerance for illiquidity in their portfolios.

ADISA believes that the issues faced by elderly investors should be the subject of guideline components tailored specifically to the issues they face. Such guidelines could include limits on the amount of their portfolios that can consist of non-traded REITs and other illiquid programs with carve-outs for investors who meet certain net worth or income requirements or carve-outs where the financial advisory firm in question employs procedures that take illiquidity, age, volatility risks and other needs into account when making recommendations to older customers. Of course, it would be preferable to allow financial advisory firms to counter or modify said limits for good cause shown (e.g., investment expertise or significant net worth). Such procedures or provisions, together with any proposed carve-outs or exceptions, should be part of a follow-up dialogue between ADISA and NASAA.

2. Liquidity

In addition to the concern discussed above, that elderly investors are frequently harmed by the illiquidity associated with non-traded REITs, the press has, at times, suggested that programs which do provide limited liquidity to shareholders do not work when liquidity is needed. As stated in articles published by the *Real Deal* and *The Wall Street Journal* and cited in the Statement, there is a belief that liquidity promised to investors disappears or dries up when it is needed most. As support for that notion, the articles point to programs that purportedly rescinded their liquidity programs or cut off additional liquidity when pre-determined limits were reached.

These criticisms ignore the fact, however, that unlimited liquidity may lead to tax disqualification or other consequences, and that cutting back or otherwise managing liquidity options is typically done in accordance with the disclosures in the prospectus AND the best interests of all program shareholders. Making programs that are designed to hold primarily illiquid assets provide additional liquidity to shareholders will cause more than an optimal amount of their portfolios to be allocated to liquid assets to support such liquidity options, and which may also negatively impact the program's overall performance and returns to all shareholders.

Just as importantly, we see clear evidence that the high levels of illiquidity associated with non-traded REITs is being reduced as sponsors and investors turn to so-called NAV REITs, which provide significantly more liquidity to shareholders than their predecessors. This shift, which has its roots in

[13] Some investments are solely designed to hedge market or other risk and do not necessarily produce an income stream (e.g., some options). Those instruments, although alternative investments because of their function, are beyond the scope of this comment letter.

FINRA's 2015 amendments to Rules 2310 and 2340,[14] has resulted in a significant switch by advisors and sponsors to NAV REITs and their attendant liquidity features.[15] Additionally, liquidity programs operated by BDCs and interval and tender offer funds, among other alternatives, allow the manager to assemble a generally illiquid portfolio and attempt to deliver the advantages that this approach can bring to investors while allowing for some (admittedly not unlimited) liquidity for those investors who need or desire liquidity.[16] It is nearly impossible to simultaneously require full liquidity from the program and still allow the sponsor/manager to create an illiquid portfolio. The limited liquidity options – which can reach as high as 20% of an NAV REIT's assets – seek to balance these two opposing investment philosophies.

We agree that such liquidity options do not distinguish between liquidity that is needed because an investor has determined to make an investment elsewhere and liquidity necessary to help an investor deal with changed circumstances. This issuer-supplied liquidity addresses – even if it does not eliminate - the concerns expressed by the Section over the acquisition of non-traded REITs by elderly investors and other investors that may thereafter experience a need for liquidity. Such liquidity is limited but available in many cases soon after the investor has acquired an interest in a program, thus allowing investors to avoid having to wait until the end of the program to access that liquidity.[17]

What is perhaps more difficult to support about a concentration limit involving non-traded programs is the likely consequence of forcing older investors to increase or maintain their exposure to volatile equity and fixed income products even as they grow older and face an ever-shortening investment horizon. And while true liquidity provides an asset owner the ability to quickly sell, there are several points to consider before enshrining liquidity as an unalloyed good: first, liquidity to sell sometimes means only the ability to sell at a significant loss; and second, liquidity itself has a price. In many cases, a known, locked-in time period prevents panic selling (for example, 401k plans are structured to foster a relatively illiquid, disciplined approach). An otherwise tight concentration limit intended to maximize investor liquidity in effect fails to take into consideration both age and wealth in the portfolio construction process and ignores the threat to retirement savings posed by an overallocation to liquid investments.[18]

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14 See FINRA RN 15-02. These changes are credited in large part with reducing up front sales charges and greater transparency into valuation and pricing.

15 According to industry data collected by Robert Stanger & Co., nearly 100% of non-traded REIT program interests acquired in the most recent fiscal year were interests in NAV REITs; Lifecycle REITs have been superseded

16 In focusing on issuer-provided liquidity options, we do not mean to obscure or ignore the increasingly efficient market for the purchase and sale of program interests. This market provides an additional source of liquidity for those looking to sell some or all of their holdings. We would be happy to fold a discussion of such options into our discussions with NASAA.

17 In regard to the liquidity programs referenced by the Section in the Statement, the *WSJ* and *Real Deal* stories created the impression that the limitations on liquidity offered by issuers such as BDCs and non-traded REITs were unexpected and not supported in the offering documents. In fact, the limits in liquidity programs established by non-traded REITs are in some cases set by applicable tax law, while those in interval funds are established by the 1940 Act. Program limits set by other programs are typically fully disclosed and are intended to balance issuer liquidity with the goal of managing and driving returns primarily from illiquid assets.

18 It has been suggested that the 60/40 stocks and bonds approach to portfolio construction, based mostly on market assumptions, suffices as a long-term strategy. This is untrue. What most do not realize is that the assumed complementary offset between stocks and bonds – both of which are liquid - is more the anomaly than the norm. There is a far more likely chance that stocks and bonds will move in the same direction (thus positively correlated to each other) than move in offsetting directions to provide balance. Publicly traded stocks and bonds are not reliable as complements in a balanced portfolio; indeed, they are almost twice as likely to move together as to move in non-correlated ways.

All investors seek diversity in investing. It has become clear that well-diversified portfolios (with market-correlated and non-correlated allocations) perform markedly better: in the last period of expansion leading to economic stress, the 10-year period from 1999-2009, the generic 60% equity/40% bond ratio after fees returned absolutely 0% while the S&P 500 Index lost 35% and the alternative asset rich Yale, Harvard, and Stanford portfolios performed from 135% to 198% in the aggregate. A historical comparison of a stock/bond portfolio with one that includes 20% private real assets from December 2008 to December 2021 shows that the addition of one single non-traded and non-correlating asset class improved performance substantially, both in terms of risk and reward.[19]

ADISA submits that the Section should consider dealing with liquidity issues not by concentration limits, but instead through requirements that liquidity program limitations exclude liquidity demands that originate due to changed circumstances; alternatively, requirements to ensure that a portion of any promised liquidity be reserved for liquidity demands associated with changed circumstances. It is ADISA's belief that the liquidity offered by NAV REITs, and other evergreen vehicles such as interval funds and BDCs, has allowed investors to maintain their investment for longer periods notwithstanding the fact that it does not currently have data to prove such belief. ADISA suggests that the Section also consider the prospect that increasingly effective secondary market purchase programs can and soon will provide liquidity that will supplement the program's liquidity discussed herein.

3. Performance

The Statement takes direct aim at what it sees as the general underperformance of non-traded REIT programs versus exchange-traded REITs. As noted in the Statement, non-traded REITs had the second most arbitrations filed in the product type of customer complaints according to FINRA data for 2021 and led all types of investments for 2020.[20] To the understanding of the Section, there are only roughly 50 companies that develop and manage REITs, BDCs, and other alternative investment products (citing to material submitted by the Institute for Portfolio Alternatives), compared to approximately 3,500 companies offering publicly traded common stock.

That said, non-traded REITs, and in particular NAV REITs, are a growing source of capital for the acquisition and development of affordable housing, commercial properties for small businesses, and other types of real estate that support economic growth and employment. According to RA Stanger data, in 2021, the NAV REIT industry raised over $36.5 billion and in the first half of 2022 raised another $21.3 billion. Recent surveys of publicly registered, non-traded REITs indicated that approximately 63% of their investments in multifamily housing support workforce housing, defined as multifamily housing with rent less than 25% of mean family income in the surrounding area. Multifamily housing made up 17.3% of non-traded REIT holdings as of June 30, 2020. Real estate can provide investors with portfolio diversification, inflation protection, a source of income, and long-term growth.

The Proposal would place arbitrary restrictions that would limit investor choice during a time of stock market volatility and high inflation. The concentration and net worth limitations, and gross income use restrictions would prevent many investors from attaining adequate portfolio diversification by investing in NAV REITs and DPPs, such as BDCs. Non-traded REITs would be targeted by the proposed blanket concentration limit approach, but we submit that they are key to diversified performance, especially during standard market downturns. We note the following performance of non-traded REITs over time in various structures (and point out that, in general, NAV REITs comprise a significant portion of current sales):

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[19] Data used for traditional include global equity (MSCI ACWI), core fixed income (Bloomberg/Barclays US Aggregate) and the private equity uses Prequin's Private RA Index, all net of fees).

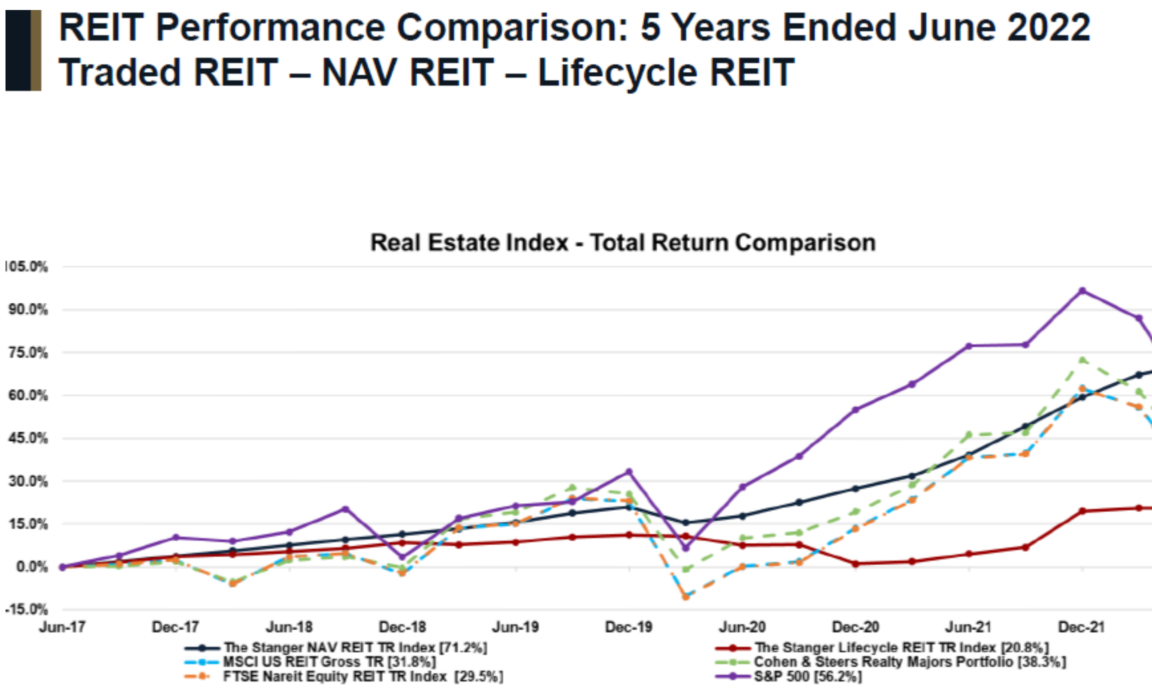
[20] The Statement cites to "FINRA Top 15 Controversy Types, https://www.finra.org/arbitration-mediation/dispute-resolution-statistics#top15securitycustomers."

• NAV REITs showed good performance during bull market years and showed superior, non-correlated performance in 2022 as the public markets declined. Since January 2017, NAV REITs have increased in value on average by 71% with little volatility.[21]

• So-called Lifecycle REITs (a legacy product) performed not as well, but with little volatility and grew about 20% overall - this was below the market, but only until recently.

• All publicly traded real estate products are correlated with the liquid securities markets and have performed poorly in its wake.

The below chart from data compiled by RA Stanger through the first half of this year is one indicator of the potential benefits associated with non-traded REITs.



Looking at performance requires a long timeframe and an understanding of the role that non-correlating assets and programs can play in investor portfolios. Looking solely at one firm's pro-plaintiff studies should not serve as a basis for policy-based action by NASAA. We submit that NASAA should consider a longer and more balanced record that will demonstrate the value of non-correlated products over time.

4. Regulation BI Issues:

There is significant hesitancy on NASAA's part to recognize that the revised conduct standards put in place under Reg BI will prove useful. This hesitancy, based on NASAA surveys as well as its own perception of adviser behavior after the implementation of Reg BI, has led the Section to seek ways to ensure that the conduct standards under Reg BI are met, understood and enforced by broker-dealers and their registered representatives. While it understands NASAA's concerns, ADISA believes that firms actually have and no doubt will continue to adopt procedures under Reg BI that will ensure compliance

[21] RA Stanger, an investment banking firm, tracks REIT performance in a quarterly *IPA/Stanger Monitor*, displayed above with several common indices.

with the letter and spirit of Reg BI. In particular, we believe that firms will continue to adopt policies and procedures requiring that the relative liquidity (or illiquidity) of an investment be taken into account when firm personnel are making recommendations to clients.[22]

The financial services industry has evolved since 2016. The SEC's adoption of Reg BI meaningfully raised the bar for financial professionals, and the DOL aimed to achieve changes in the market by adopting its 2016 "fiduciary" rule.[23] There is data showing that these regulations resulted in meaningful changes to the marketplace, making unnecessary any thought of resurrecting the 2016 DOL rule. For example, there has been a decline in commissions and 12b-1 income, a shift to fee-based models, a decline in expense ratios, increased competition in fee-based models, and a slowdown in IRA rollovers from other retirement plans.

Rather than base its approach on a belief that Reg BI cannot perform its intended role and bring up the standard of conduct at financial advisory firms, NASAA should review its studies (and possibly redo them) to capture more and different data points. ADISA believes that this additional data will show that firms are adopting and implementing policies and procedures required by the Reg BI. ADISA also believes that the SEC's enforcement efforts in this regard are having a material effect and raising the standard of conduct all over the industry. In ADISA's view, Reg BI can and will be an important part of the landscape and will continue to move the financial advisory industry toward fully robust product selection and recommendation standards.

5. Ensuring Access to Alternatives

The Proposal would not only affect publicly registered, non-traded REITs but would indirectly affect other highly regulated investment vehicles offered by premier asset management companies, including interval funds, tender offer funds and BDCs that seek to produce non-correlated returns. Fostering development of and access to these alternative investments should be high on NASAA's wish list. Some 78% of "Millennials" and 70% of "Gen X'ers" endorse using alternatives, compared with only 58% of so-called "baby boomers" (Natixis, 2014). If the Proposal has the effect of restricting access by future generations to alternatives, there will likely be a tendency for them to move to lower cost commoditized digital advice. As has been shown, however, this increases herd behavior and amplifies catastrophic market risks. Indeed robo-advisers typically only use self-reported risk tolerance—not age or wealth level—to derive a generic portfolio. This cannot be the path that we want younger investors to follow.

Moving the suitability standards upward, even if to account for inflation, presents the possibility of further negatives consequences. It would have the potential to lock out small balance and otherwise less wealthy and/or non-traditional investors from acquiring alternative assets for their savings and retirement portfolios. As shown above, the benefits of adding non-correlating assets to a portfolio are substantial. What is important to note is that these benefits do not exclusively run to investors with higher wealth levels. Smaller balance and lower net worth (even non-traditional) investors need to insulate their portfolios from the vagaries of the traded securities markets so that they can effectively work to close long-standing wealth gaps; raising the net worth and income requirements may have the unintended effect of denying non-correlating and less volatile investments to persons who may need them most.

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22 We note in this regard that the guidelines are applied to program sponsors and yet most of these proposed changes would in fact impact the broker-dealers and others that sell or recommend these products.

23 Even though the rule was enjoined by the U.S. Court of Appeals for the Fifth Circuit, many firms were prepared for the rules implementation and had gone to significant lengths to create and introduce policies to ensure compliance with the Rule. In most if not all cases, firms left these procedures in place and adjusted them to the requirements of Reg BI rather than adopting new procedures.

At the same time, the Section's decision not to add a carve out for accredited investors and others who meet net worth, income and/or qualification standards set by NASAA means that persons with substantial financial resources and wherewithal will be subject to the same limits as persons who lack such resources. Persons meeting the accredited investor standard can acquire securities in private placements, which have the fewest protections available to investors. Given NASAA's long standing pro-investor stance, NASAA should work to ensure that investors are not disincentivized to invest in products that offer more investor protection. Given the substantial investor protections present in non-traded REITs as well as BDCs and other DPPs, it makes sense to carve out accredited investors (or those meeting alternative criteria defined by NASAA), from the effect of the Proposal.

If NASAA is to have a positive impact on investing behavior for smaller and newer investors as well as those with substantial resources, it should look at ways to enhance and not limit the availability and usability of alternatives in investor portfolios. All too often regulators are forced to rectify problems created by action or inaction of others. ADISA suggests that this is a rare opportunity for NASAA to create regulations that are not based solely on preventing bad behavior but instead that can also encourage well-informed independence by making sure investors of all stripes have access to the greatest number of alternative investments while ensuring investor protections.

ADISA appreciates the work of the Section and the Project Group, and their desire to enable investors to prosper. In our view, this means ensuring access to a wide variety of appropriate alternative investment products using procedures designed to ensure that investors' interests are not placed behind those of their advisers. We look forward to assisting you in these efforts in any way that is useful.

Sincerely,

John H. Grady /JR
John H. Grady
Co-Chair

Catherine Bowman /JR
Catherine Bowman
Co-Chair

ADISA Legislative & Regulatory Committee

Cc: Drafting Committee: John Grady, Catherine Bowman, Deborah Froling, John Harrison
Thomas Rosenfield and Anne Darconte, HillStaffer LLC