**Via Electronic Submission: NASAAComments@nasaa.org**

September 12, 2022

NASAA Corporation Finance Section
C/O North American Securities Administrators Association, Inc
750 First Street, NE
Suite 1140
Washington, D.C. 20002

Re: **Proposed Revisions to the NASAA Statement of Policy**
**<u>Regarding Real Estate Investment Trusts</u>**

Ladies and Gentlemen:

This will serve as comments of Cetera Financial Group ("Cetera") in connection with proposed revisions to the NASAA Statement of Policy Regarding Real Estate Investment Trusts. We will refer to the current version as the "Statement of Policy" and to the revisions proposed on July 12, 2022, as the "Proposal".

Cetera is the corporate parent of five broker-dealers and three investment advisers. We have more than 8,000 affiliated representatives serving more than 1 million customers in all 50 states. Our customer base consists primarily of individual investors and small business owners seeking advice to help them reach investment goals including saving for retirement, education funding for their families, and enhancement of inheritances and other legacies. Most of our financial professionals offer both commission-based brokerage services and fee-based investment advisory services to their customers.

Given our large and diverse client base, we offer a full menu of investment products and services to our customers. These include individual equities and fixed income instruments, mutual funds, exchange-traded funds, insurance and annuity products, and alternative investments including Non-traded Real Estate Investment Trusts ("NTRs"). Our product menu includes securities from virtually all major investment product sponsors, and Cetera does not offer proprietary investment funds. Alternative investments represent a relatively small percentage of our total revenue, but serving the needs of our many customers requires that we offer a number of such investments, including NTRs, non-traded Business Development Companies, and interval funds.

## <u>Summary of Our Comments</u>

The Proposal is well-intentioned, but fundamental aspects of it represent a solution in search of a problem. It would make significant and unnecessary changes that would reduce investor choice and access to investment products without enhancing investor protection.

When considering changes to the existing framework regarding recommendation of investments to retail investors by financial professionals, it should be borne in mind that a comprehensive regime already exists. SEC Regulation Best Interest ("Reg. BI") was adopted in 2020 and applies to all recommendations to purchase, sell, or hold securities made by a broker-dealer or investment adviser. FINRA rules expand upon the requirements of Reg. BI, and the Employee Retirement Income Security Act of 1974 ("ERISA") also applies to all recommendations to purchase or sell investments in retirement savings plans and includes conduct standards similar to those in Reg. BI.

The Proposal states that one of its goals is to create a higher degree of uniformity among state regulations applicable to recommendations to purchase interests in NTRs. In fact, it's adoption will accomplish exactly the opposite result. It would create duplicative and potentially conflicting standards which will create confusion for both investors and financial professionals.

Reg. BI was adopted by the SEC to serve as a national standard for all broker-dealers and investment advisers dealing with retail customers. We recognize that some NASAA constituencies believe that Reg. BI does not contain all of the elements they would have preferred, but it has only been in effect for two years. Instead trying to work in harmony with Reg. BI and improve the national standard applicable to all financial professionals and investment products, the Proposal veers off into an entirely different direction. It should be withdrawn and reconsidered after consultation with members of the securities industry and representatives of public investors.

**Evolution of Non-Traded REITs – 1996 to the Present**

The Statement of Policy was originally published in 1996. It underwent minor revisions in 2007, but has remained substantially unchanged since then. During the more than 25 years since its adoption, important changes have occurred in the market for NTRs and the ways in which they are structured and sold. The original Statement of Policy may have made sense when applied to the NTR market in 1996, but neither it nor the Proposal take into account the evolution that has occurred since that time.

From the time at which the Statement of Policy was adopted through approximately 2015, most NTRs were structured as "lifecycle" REITs. They raised capital, invested it in real estate or related assets, paid distributions to investors, and ended their existence with "liquidity events" such as a public listing of their shares or sale of their assets to third parties. Lifecyle REITs were often characterized by high offering expenses, (up to 10% of the capital raised, including sales charges up to 7%), numerous fees charged by sponsors in connection with the management and disposition of the assets, lack of liquidity for investors, and limited transparency regarding the value of the assets in the funds. The fee structure often created incentives for the sponsor to act in ways that were not fully aligned with those of investors.

Beginning in approximately 2015, a number of large and well-known institutional asset managers entered the market as sponsors of NTRs. They included firms such as Blackstone, Ares Capital Management, KKR, and Starwood. These sponsors had traditionally managed real estate and other assets for large institutions such as public and private pension funds and sovereign wealth funds, and had demonstrated an ability to produce superior returns for their investors. By contrast, many NTR sponsors prior to 2015 were smaller firms whose primary or only business was sales of NTRs to individual investors. The offerings they sponsored tended to be smaller in size and in structures that included the higher fees and other features referred to above.

Institutional asset managers have traditionally utilized a fee model which consists of a relatively small management fee (1.0% - 1.5% annually) plus an incentive fee based on investment performance, and the entry of institutional investment sponsors led to significant shifts in how NTRs are structured and managed. Virtually all of the NTRs that are offered today are known as "NAV ("Net Asset Value") REITs" and have substantially eliminated many of the concerns that were addressed in the original Statement of Policy and that have resurfaced in the Proposal.

These changes include:

- NAV REITs are so-called because their assets are appraised and valued by independent third parties on a regular (usually quarterly or annual) basis. Shareholders have the ability to liquidate their shares at the published net asset value monthly or quarterly, subject to overall volume limits.

- FINRA adopted changes to its rules regarding how the value of NTRs and other non-traded investment products were reported on customer statements issued to investors. This dramatically reduced the lack of transparency in valuation of NTR programs.[1]

- NAV REITs are designed to have perpetual life. Instead of relying on liquidity events such as public listings or sales of assets, NAV REITs are intended to operate indefinitely. They buy and sell assets as they seek to accomplish their investment objectives and earn returns for their investors. Investors are no longer required wait for a liquidity event to exit their investment since they can redeem their shareholdings on a regular basis.

- Upfront sales charges for NTRs have been reduced dramatically. Recent data indicates that the majority of NTR shares are currently sold without a sales charge, and that virtually all sales consist of share classes with upfront sales charges under 3.5%.[2] This has reduced expenses, led to higher overall returns for investors, and better aligned the interests of financial advisers and purchasers.

These developments occurred in response to both market forces and regulatory action, but also in recognition of the fact that real estate is generally intended to be a long-term investment. NTRs have benefits for investors, including a lower level of price volatility than typically exists for shares of publicly-traded REITs. Investors who liquidate NTR holdings receive the NAV of their shares as determined by independent appraisals rather than in public markets where shares often trade at significant discounts to NAV. Retirement savings plans, particularly Individual Retirement Accounts ("IRAs") are a significant source of purchases of NTRs and are consistent with their long-term character and relatively lower need for liquidity.

With all of the above as background, we offer the following specific comments with respect to the Proposal.

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[1] See FINRA Regulatory Notice 15-02.
[2] Stanger Market Pulse, June 2022. (Rastanger.com/publications)

## I. The Proposal Would Create Significant and Unjustified Restrictions on Investor Choice Without Enhancing Investor Protection.

The vast majority of NTR shares are purchased through broker-dealers and investment advisers. In 2020, the SEC adopted Reg. BI, which imposed specific obligations on financial professionals when making investment recommendations to retail customers. It requires financial professionals to act in the best interest of investors by applying specific conduct standards to all recommendations. FINRA Rule 2111, to which all broker-dealers are subject, contains similar but more detailed requirements.

ERISA also imposes obligations on financial intermediaries who recommend investment purchases to plan sponsors and beneficiaries of most tax-qualified retirement savings plans, including IRAs. ERISA and Prohibited Transaction Exemption 2020-02 include conduct standards for financial professionals that are essentially equivalent to those in Reg. BI.

***A key factor of all of these conduct standards is that they apply equally to all recommendations to purchase securities, regardless of the investment product***. This represents a deliberate and considered choice by the SEC, FINRA, and the Department of Labor, because they recognized that the circumstances, needs, and objectives of every investor are different. Most investors maintain a portfolio of investments, and each is intended to produce a particular result. Provisions that favor or disfavor any type of investment product are likely to create artificial barriers that will not benefit investors.

The Proposal would prohibit broker-dealers from recommending that a customer invest more than 10% of their liquid net worth in an NTR or a combination of investments that include NTRs. This raises a number of significant problems:

1. The proposed limitation is directed to a specific type of investments. This is in direct conflict with the approach of Reg. BI, ERISA, and FINRA rules, all of which are product-neutral. More importantly, it fails to take into account the fact that the situation of every investor is different. A 40-year-old orthopedic surgeon with an annual income of $1 million and a medical practice worth $10 million is in a completely different position than an 80-year-old retiree on a fixed income, yet the Proposal would apply the same concentration limit to both of them. This completely ignores the nature of the best interest obligation in Reg. BI by applying an artificial limit that prevents the financial professional from taking a holistic view of each customer and how their investment objectives will best be accomplished.

   Reg. BI is specifically designed to require broker-dealers and other financial professionals to implement processes that are calculated to best serve their customers, including the type and quantity of investments that they recommend. Reg. BI and FINRA rules also contain specific provisions with respect to the quantity of investments that may be recommended to a customer.[3] Cetera and most other broker-dealers apply concentration limits to

[3] See: Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 F.R. 33,318 at 33,444 – 45 (July 12, 2019) and FINRA Regulatory Notice 20-18.

purchases of specified investment products, including NTRs. However, instead of the rigid, one-size-fits-all approach taken by the Proposal, broker-dealers take into account the age, experience, assets, investment objectives, and risk tolerance of the investor. It only stands to reason that the investment portfolio of the 40-year-old orthopedic surgeon will be different than that of the 80-year-old retiree.

2. The Proposal would aggregate all securities offered by the issuer, its affiliates, and other non-traded "directed participation programs" in determining the 10% concentration limit. This raises a number of issues:

    a. The term "other non-traded direct participation programs" is not defined. Direct Participation Programs are regulated under FINRA rules, but the category does not include REITs.[4] Determining which investments fit the description in the Proposal would require subjective judgments by both issuers and financial professionals. This is not a workable standard.

    b. The term "liquid net worth" is defined to include cash, cash equivalents, and marketable securities. This definition is far too restrictive, and would prevent a customer with a $100 million of privately-owned assets and $1 million of cash and cash equivalents from investing more than $100,000 (0.10% of their net worth) in NTRs or other similar investments. This creates an unnecessary restriction on investor choice and the ability of financial professionals to make recommendations in the best interest of customers.

    c. The Proposal would allow state administrators to change the 10% concentration limit with respect to specific offerings. Flexibility is usually a good thing, but the possibility that individual state administrators will utilize their discretion in arbitrary or conflicting ways creates unjustified and poorly understood differences in the availability of investment products. This is not desirable for either financial professionals or investors .

       Vesting discretion in individual state administrators also undercuts the important objective of creating uniformity among the states, which the Proposal states as one of its goals. The legal framework for securities offerings in the United States is designed to facilitate the formation of capital by applying a disclosure-based national standard for both issuers and intermediaries. The Proposal would undercut this important policy objective.

    d. The Proposal would apply an aggregated 10% concentration limit to all investments offered by "affiliates". The Term "affiliate" is defined in the Statement of Policy in a very broad fashion, and would appear to prohibit a financial professional from recommending that a customer invest more than 10% of their liquid net worth in any combination of securities sponsored by related entities. As noted above, the NTR market is currently dominated by large institutional asset managers. Most of them offer NTRs, mutual funds, and other investment vehicles of various types. The

[4] See FINRA Rule 2310(a)(4)

Proposal would prohibit a recommendation to invest more than 10% of an investor's liquid net worth in any combination of NTRs, mutual funds, or any other securities offered by sponsors that are corporate affiliates. It is hard to argue that this is in in the best interest of customers.

Reg. BI and the obligations of financial professionals to act in the best interest of their customers were deliberately made product-neutral. This represented the considered judgment of the SEC that applying product-specific standards is not calculated to lead to the optimal balance of investor protection and investor choice. The Direct Participation Project Group clearly recognizes that a significant number of states may not adopt the Proposal. That will inevitably lead to a patchwork of different and conflicting state standards. That is not in the interest of anyone.

## II. The Proposal does not cite objective evidence sufficient to justify the substantive changes it would cause.

It is a fundamental principle of administrative regulation that an agency proposing a regulation must articulate a rationale for why the regulation is necessary to address a perceived issue or problem, that it does so in the most effective and least intrusive manner, and has considered all of its related effects after an examination of objective evidence. We will offer comments below regarding the somewhat unusual role that NASAA Statements of Policy play in state securities regulation, but the threshold issue in this case is that the Proposal fails to make a valid case for many of its provisions. We note the following examples:

A. **Concentration limits -** In support of the need for concentration limits, the Proposal cites cases in which NTRs suspended or declined to honor redemption requests from investors. The examples noted are literally accurate, but incomplete and therefore misleading. The summary omits two key facts that are necessary to give it appropriate context:

1. All of the instances noted appear to have taken place in 2020. The COVID-19 pandemic burst upon the world in February, 2020, inspiring a public health crisis and government actions that had not been seen in the U.S. in more than 100 years. Almost immediately, most workers could not go to their offices or work in other collective environments. This led some investors and commentators to conclude that a large number of office tenants would cease making rent payments, that demand for commercial office space would diminish, and that investors in real estate would suffer enormous investment losses.

   In response to the COVID-19 pandemic, all prudent directors of NTRs assessed the financial circumstances of the funds for which they were responsible and the potential impacts of the COVID-19 pandemic. Given the truly unprecedented nature of the public health crisis, many directors concluded that the most prudent course was to suspend distributions or decline to honor distribution requests for a period of time pending additional clarity about what might happen in the future.

   These actions were an appropriate and necessary response to a set of circumstances that no one could have anticipated or known how to deal with. More importantly:

- Virtually all of the NTRs cited in the Proposal quickly resumed payment of distributions within a relatively short time;

- These NTRs represent a very small percentage of both the number of NTRs in the market and an even smaller percentage of the invested capital; and

- The COVID-19 pandemic first became known to the public in late February 2020. From February 19, 2020 through March 23, 2020, the Standard and Poor's 500 stock index, the most common measure of the overall value of U.S. equities, dropped nearly 35%. Equity values subsequently recovered, but virtually all investors in the U.S experienced significant declines in the value of their portfolios during that period.

Investment risk comes in many forms, of which lack of liquidity is only one. The vast majority of all NTRs resumed paying distributions before the end of 2020.

The Proposal suggests that investors should be restricted from purchasing securities that are not publicly traded in order to protect them from bad investment outcomes, and cites the suspension of distributions by certain NTRs as an example. This is misleading at best and does not support the need for revisions so drastic.

**B. Multiple and conflicting conduct standards**

Guideline III.C.3. in the Proposal incorporates the provisions of Reg. BI into the conduct standards applicable to recommendations to purchase NTRs. This raises a number of issues:

1. Reg. BI, FINRA rules, and ERISA already apply to all investment recommendations to retail investors. Incorporating this provision adds nothing in terms of investor protection and creates uncertainty about the exact scope of the obligations attached to recommendations for specific investment products.

2. The Proposal cites data regarding arbitration claims filed against FINRA member firms in 2020 and 2021 as support for the proposition that NTRs comprise a disproportionate number of the total number of arbitration claims and therefore require special restrictions. The data cited in the Proposal regarding the number of arbitration claims appears to be literally true, but is at best misleading. FINRA arbitration cases commonly include numerous legal theories (violation of law or industry regulations, negligence, breach of contract, and breach of fiduciary duty) and numerous different investments that were purchased by the claimant. The fact that any given arbitration claim includes a certain investment product is only half of the story. None of the data cited in the Proposal establishes any causal link between investment types in arbitration proceedings and either the claims against the firm or the source of any alleged damages. We would also note that the large majority of arbitration claims filed with FINRA are either resolved by mutual agreement or dismissed after a hearing. The data cited in the Proposal reveals nothing about the merits of any claim

or the outcome of the matter. In and of itself, this is not compelling evidence of anything.

3. The Proposal cites a report produced by a the NASAA Reg. BI Implementation Committee as support for the proposition that NTRs present special risks to investors that justify stricter regulation.[5] That report was prepared utilizing information gathered in two surveys conducted by the Committee. A full discussion of the infirmities of both the report and the underlying surveys is beyond the scope of this letter, but we would note that, on February 24, 2020, shortly after the initial survey was distributed to broker-dealers and investment advisers, a group of securities industry trade organizations submitted a letter to the Reg. BI Implementation Committee pointing out a number of flaws in the survey methodology and requesting input into how future surveys were designed and utilized. The Committee declined that request, and subsequently prepared and distributed a second survey that had many of the same flaws.

   After publication of the NASAA report, a group of industry trade organizations commissioned a study (the "Greenwald Study")[6] of the findings. The findings of the Greenwald Study noted serious structural flaws in design of both the surveys and the reports and why their conclusions were not supportable.

   A side-by-side comparison of the NASAA Report and the Greenwald Study make clear that the findings of the NASAA report do not meet the standard of objective evidence that should be required in connection with adoption of regulations as substantive as these.

**C. Use of offering proceeds**

The Proposal would restrict the ability of NTRs to pay distributions from offering proceeds. This represents an unnecessary and unwarranted intrusion on the discretion of fund directors, all of whom have fiduciary obligations to both the funds and shareholders and are required to act in their best interest. More importantly, the Proposal cites no evidence for the proposition that use of offering proceeds to pay distributions has ever resulted in harm to investors. We are unaware of any such instance, and assume that if it had occurred, it would have been noted in the Proposal. This appears to be another instance of a solution in search of a problem.

We would also note that many NTRs are simultaneously engaged in share offerings and payment of distributions to shareholders. Current SEC regulations require NTRs to

[5] Proposal, at Footnote 6.
[6] ANALYSIS OF NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION'S (NASAA) REG BI SURVEYS Prepared by Greenwald Research FEBRUARY 2022, available at https://greenwaldresearch.com/wp-content/uploads/2022/02/Analysis-of-NASAA-Surveys-on-Reg-BI-Greenwald-Research-2.22.pdf.

disclose the source of distributions.[7] Limitations on the ability pay distributions adds needless complexity and adds little in the way of investor protection.

## III. The Proposal conflicts with provisions of federal law and is likely not enforceable.

The Proposal contains several provisions that are in conflict with federal law. They include the following:

**A.** The Proposal would impose a concentration limit not only for investments in NTRs as a class but also an aggregate limit when combined with other securities offered by the sponsor or its affiliates, some of which may be registered investment companies. The Securities Act of 1933 prohibits states from even indirectly registering or qualifying investment company securities.[8] The Proposal would effectively impose a condition on the offering of investment company shares in a state – that no investor exceed the state's aggregated concentration limits – in contravention of the notice filing provisions.

The aggregation provision is not only contrary to federal law, but would also have a negative impact on investors. Many large asset managers offer NTRs and other similar non-traded investment products in addition to investment company securities. We assume that it was not the intent of the Proposal to place limits on the ability of investors to purchase mutual funds of specific issuers, but that would be the practical effect of this provision.

**B.** Most NTRs are currently structured as corporations under the laws of the state of Maryland. This is largely due to the fact that Maryland law is well-established with respect to REITs and therefore more predictable for both fund sponsors and investors. However, investment funds that focus on real estate can often be structured as investment companies under the Investment Company Act of 1940. This is not the preferred alternative for most funds due to the higher ongoing expenses associated with operating investment companies, all of which are borne by fund shareholders. That being said, if faced with burdensome restrictions on their ability to raise capital, many sponsors of NTRs may decide to structure their new REIT offerings as investment companies. This would have two important effects: It would deprive state securities agencies of any authority to review or approve the terms of NTR offerings. It would also eliminate the registration fees paid to the states in connection with NTR offerings in the future. We assume that this would have a negative effect on the operating budgets of state securities agencies and would be undesirable.

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[7] SEC Division of Corporation Finance, CF Disclosure Guidance: Topic No. 6, Staff Observations Regarding Disclosures of Non-Traded Real Estate Investment Trusts, July 16, 2013, available at https://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic6.htm ("SEC Disclosure Guidance: Topic No. 6").

[8] Section 18, Securities Act of 1933, 15 U.S.C Section 77r

## IV. The Proposal and Statements of Policy in general are not the appropriate vehicle for consideration of such significant policy issues.

Statements of Policy developed by NASAA are important resources for state securities administrators. They cover a wide range of issues and often create frameworks that states can adopt or modify. Statements of policy represent an appropriate mechanism for matters that are primarily technical in nature or are not complicated or controversial, but the Proposal clearly does not fall into either of those categories.

NASAA Statements of Policy are reviewed and adopted in different ways, depending on the laws of individual states. Some states require that adoption be subject to the formal statutory provisions which require notice to the public and opportunity to comment before regulations are adopted. Most such states also require agencies to present specific types of analysis, economic and otherwise, in order prior to adopting regulations.[9] Other states provide that NASAA Statements of Policy are either automatically incorporated into securities regulations or may be at the discretion of the state administrator.[10] A third group of states does not appear to have specific provisions governing use of Statements of Policy.

The bottom line is that there is no consistency regarding how NASAA Statements of Policy are incorporated into the regulations of the 50 states. The Proposal would have significant nationwide impacts on capital formation and investor choice. These issues are simply too important to be adopted under such varying circumstances without an opportunity for full consideration in each state. Capital markets are global and capital flows do not observe state borders. Adoption of any regulation that has the potential impacts of the Proposal should only be undertaken after a formal process in each state, including public notice and the opportunity for comment.

The Proposal also notes that it may serve as a model for future NASAA Statements of Policy or other rulemaking activity. This emphasizes the necessity for a rigorous and comprehensive review of the Proposal, not only on its own, but as part of the overall framework of state securities regulation.

## V. Adjusting suitability standards to reflect inflation is a concept worth considering.

Reg. BI establishes a framework that strikes the appropriate balance between investor protection and maintaining investor choice by requiring financial professionals to act in the best interest of customers. We believe that this obviates the need to apply a specified level of income or net worth for prospective purchasers of any investment product, including NTRs. That being said, we recognize that virtually all states currently have standards regarding minimum amounts of investor income and net worth, and product sponsors and distributors seem to have adapted to them. If such standards are to exist, adjusting them to account for the impact of inflation may be appropriate.

The minimum standard for purchasers of NTRs in most states is currently a combination of $70,000 in annual income plus $70,000 of net worth ***or*** net worth of $250,000. The Proposal would raise these limits to reflect the impact of price inflation over time. Cetera currently has internal standards

[9] These states include: Alaska, Arizona, Hawaii, Indiana, Iowa, Kansas, Missouri, Nebraska, North Dakota, Texas, and Virginia.
[10] These states include: Alabama, Arkansas, Idaho, Mississippi, New Mexico, Oklahoma, Pennsylvania, Tennessee, and Utah.

relating minimum levels of income and net worth for illiquid investment products, some of which may be stricter than those established by state regulations. We do not believe that any rigid concentration limit should be established, but raising the required minimum income or net worth based on price inflation is worthy of consideration.

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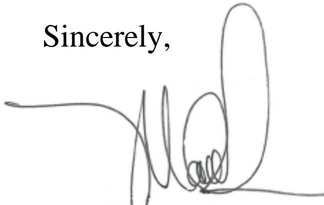
Thank you for providing us with an opportunity to submit comments regarding this important matter. Cetera is committed to constructive engagement with all regulatory agencies in our common pursuit of investor protection and enhancement of the ability to meet their investment goals. If we may offer any further information on any of the matters discussed herein, please let me know.

Sincerely,



Mark Quinn
Director of Regulatory Affairs
Cetera Financial Group

CC: Andrea Seidt, Esq. – Chair, NASAA Corporate Finance Section Andrea.Seidt@com.ohio.gov
Mark Heuerman, Esq. – Chair, NASAA Direct Participation Programs Project Group
Mark.heuerman@com.ohio.gov