September 12, 2022

Via Email to nasaacomments@nasaa.org
NASAA
750 First Street, NE, Suite 1140
Washington, DC 20002

Re: Proposed Revisions to NASAA Statement of Policy Regarding Real Estate Investment Trusts

Dear Ms. Seidt and Mr. Heuerman:

On behalf of the undersigned organizations, we write in strong support of the proposed revisions to NASAA's Statement of Policy Regarding Real Estate Investment Trusts (REITs), which would enhance protections surrounding the offer and sale of non-traded REITs to retail investors.

The four primary revisions being proposed include: (1) an update to the conduct standards for brokers selling non-traded REITs, i.e., supplementing the suitability section with references to the Regulation Best Interest standard of conduct; (2) an update to the net income and net worth financial figures in the suitability section, i.e., adjusting upward to account for inflation occurring since the last adjustment; (3) the addition of a new standardized concentration limit to the suitability section; and (4) the addition of a new prohibition against using gross offering proceeds as an investment objective or strategy to make distributions.

I. Background on Non-Traded REITs

A Real Estate Investment Trust (REIT) is a company that owns – and typically operates – real estate or real estate-related assets. Investing through REITs can be beneficial as REITs can provide exposure to real estate without requiring an investor to actually buy or sell real property. There are different types of REITs, including those, like public company stocks, that are listed and traded on national securities exchanges. Non-traded REITs, on the other hand, are not listed or traded on national securities exchanges.

Non-traded REITs are often marketed and sold to retail investors, including retirement savers, as high-yield and predictable assets. However, these assets come with significant risks, including liquidity risk, valuation risk, income risk, and principal risk. In addition, non-traded REITs are extraordinarily high-cost investments that can drain retail investors' hard-earned money and underperform more liquid and diversified alternatives. Finally, non-traded REITs are rife with conflicts of interest, which expose retail investors to further harm. Given these risks and costs to retail investors, it is entirely appropriate for NASAA to update its policy regarding REITs to ensure that retail investors receive the protections they need and deserve.

- **Liquidity Risk and Valuation Risk**

Unlike traded REITs, which are listed and traded on public exchanges, non-traded REITs are sold directly by broker-dealers. Because non-traded REITs don't trade on exchanges, which provide real-time price transparency, non-traded REITs are extremely difficult to value accurately and fairly.

In addition, non-traded REITs can only be sold to other investors or back to brokers during limited times, usually only after the investor has held the asset for a year. Sales may be subject to additional significant and sometimes ad-hoc restrictions imposed by management. For example, at the onset of the pandemic, several non-traded REIT companies suspended redemptions.[1] According to a *Wall Street Journal* article at the time, "For many small investors, their inability to cash out their shares couldn't come at a worse time, with the economy reeling and millions joining the ranks of the unemployed."[2]

The extreme difficulty in valuing non-traded REITs and severe restrictions on their sale means they typically cannot be sold within a reasonable timeframe.[3] If investors are able to sell these investments at all, they often are forced to sell at substantially lower prices than they originally paid.

- **Non-traded REITs are Extraordinarily High-Cost Investments**

Non-traded REITs can drain retail investors' hard-earned money and underperform more liquid and diversified alternatives. According to research by Brian Henderson, Joshua Mallett, and Craig McCann at the Securities Litigation and Consulting Group published in 2015,[4] non-traded REIT investors pay up-front fees that average 13.2 percent of the purchase amount and in some cases are as high as 16.0 percent. These fees dramatically reduce the capital available to purchase portfolio holdings. A significant chunk of these costs goes to the brokers who recommend these products.

While non-traded REITs are often advertised as high-yield assets, their actual performance statistics tell a different story. According to the researchers' analysis, non-traded REITs underperform traded REITs by approximately 7.3 percent annually (11.3 percent for a diversified portfolio of traded REITs vs. 4 percent for the non-traded REITs sample they examined). Based on this underperformance, the researchers estimated that investors are at least $45 billion worse off as a result of investing in those non-traded REITs than they would have been if they had merely invested in a diversified portfolio of traded REITs. In fact, investors in

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[1] *See* Peter Grant, *Individual Investors Find Withdrawal Window Shut for Property Funds; Inability to cash out shares in nontraded REITs couldn't come at a worse time for many small investors*, WALL STREET JOURNAL, April 14, 2020, https://www.wsj.com/articles/individual-investors-find-withdrawal-window-shut-for-property-funds-11586865601.

[2] *Id*.

[3] *Id*. ("Other nontraded REITs have stopped redemptions because they have no way of putting a fair value on the real-estate assets in the funds or the shares that investors are trying to cash out.").

[4] Brian Henderson, PhD, CFA, Joshua Mallett, CPA, and Craig McCann, PhD, CFA, *An Empirical Analysis of Non-Traded REITs*, SECURITIES LITIGATION AND CONSULTING GROUP, 2015, https://www.slcg.com/files/research-papers/Henderson%20Mallett%20McCann%20non-traded%20REITs.pdf

non-traded REITs would have earned the same performance in short and intermediate term Treasury mutual funds without the high risks and extreme illiquidity of non-traded REITs.

When Mallett and McCann recently updated their analysis through 2019, their research confirmed that the high costs, relative underperformance, and conflicts of interest that retail investors suffer have persisted.[5] Specifically, they found that non-traded REITs as a group underperformed traded REITs by approximately 8 percent annually. The dollar losses from investing in non-traded REITs instead of traded REITs exceeded $75 billion as of December 31, 2019. The underperformance did not decrease over time.

- **Non-traded REITs are Characterized by Harmful Conflicts of Interest in Both their Management Structures and Sales Practices**

Non-traded REITs are rife with conflicts of interest both in how they are governed and how they are sold. Often the entities that manage and sell non-traded REITs are closely affiliated and controlled by the same top executives who divvy up the high upfront costs investors pay. These conflicted structures enable a systematic wealth transfer from retail investors who need to make every dollar count to the financial firms that create, manage, market, and sell these products.

The risks and costs that non-traded REITs impose on retail investors, coupled with the recent record sales of non-traded REITs,[6] necessitate an update to NASAA policy regarding REITs.

II. Proposed Revisions

The first revision recommended in this Notice is to update the REIT Guidelines by formally incorporating Regulation Best Interest's standard of conduct as well as any other updated conduct standards that are adopted by the NASAA jurisdictions as applied to brokers recommending these securities. This would make it clear that a broker must comply with currently applicable conduct standards, including Regulation Best Interest, and that otherwise complying with the policy requirements does not excuse a broker from complying with these conduct standards. These changes would help to ensure that brokers understand that they are subject to a standard that is higher than the previous suitability rule when they recommend and sell non-traded REITs. Further, these changes would help to clarify these conduct standards so that brokers are not under the misimpression that, merely because a client signs a statement acknowledging that they are qualified for the investment, the broker will be relieved from

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[5] 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.

[6] Beth Mattson-Teig, Non-Traded REITs Continue to Grab Record Capital Inflows, Wealth Management, May 23, 2022, https://www.wealthmanagement.com/reits/non-traded-reits-continue-grab-record-capital-inflows ("The non-traded REIT sector is on a blistering pace of fundraising. Capital inflows hit a record high of $36.5 billion last year, which is more than triple the $10.9 billion in capital raised in 2020, according to data from Robert A. Stanger & Co. Inc. The investment banking firm is forecasting an even bigger year ahead, and the market is off to a strong with $12.2 billion in capital raised during first quarter….Sponsors are devoting more resources to expanding sales channels to attract more retail investors to their platforms.")

complying fully with the standards of conduct. These changes would also help promote uniformity with federal securities law.

The second revision recommended in this Notice is to update the net income and net worth figures in the suitability section of the prospectus, by adjusting these figures upward for inflation. The current figures have not been updated since May 7, 2007. In the decade and a half since then, our nation has experienced significant inflation,[7] which has undermined the effectiveness of the current thresholds. If these thresholds are not raised, it is more likely that non-traded REITs will be sold to investors who cannot bear the risks of these products and these investors will be at greater risk of suffering harm. Indeed, we believe the REIT Guidelines should increase the net income and net worth thresholds beyond accounting for inflation in order to better protect retail investors from these products' risks.

The third revision recommended in this Notice is to add a specific concentration limit within the REIT Guidelines prohibiting an aggregate investment in the issuer, its affiliates, and other non-traded direct participation programs that exceeds 10% of the purchaser's liquid net worth. This concentration limit would help to ensure that investors do not lock up their entire portfolio in these risky, illiquid products. Instead, it would help to ensure that investors maintain adequate diversification among their investments such that they are not overly exposed to the risk of loss or illiquidity from a single investment or single type of investment. For these same reasons, we strongly support not providing a carve-out for "accredited investors," particularly given that the accredited investor standard has not been updated to reflect inflation since 1982.[8]

We also strongly support applying the concentration limit to all affiliates, including business development company (BDC) affiliates. Non-traded BDCs raise the same concerns as non-traded REITs, as both kinds of products can expose retail investors to liquidity risk, valuation risk, income risk, and principal risk,[9] in addition to being high-cost investments that can drain retail investors' hard-earned money and expose retail investors to harmful conflicts of interest. Also, like non-traded REITs, non-traded BDCs have experienced record sales recently.[10]

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[7] For example, according to the CPI Inflation Calculator on the Bureau of Labor Statistics website, $100 in May 2007 has the same buying power as $142.49 in June 2022. https://www.bls.gov/data/inflation_calculator.htm; *See also* Bureau of Labor Statistics, U.S. Department of Labor, The Economics Daily, Consumer prices up 9.1 percent over the year ended June 2022, largest increase in 40 years at https://www.bls.gov/opub/ted/2022/consumer-prices-up-9-1-percent-over-the-year-ended-june-2022-largest-increase-in-40-years.htm.

[8] *See* Commissioners Allison Herren Lee and Caroline Crenshaw, Joint Statement on the Failure to Modernize the Accredited Investor Definition, August 26, 2020, https://www.sec.gov/news/public-statement/lee-crenshaw-accredited-investor-2020-08-26

[9] *See* Evaluating Non-Traded BDCs, CNL Securities, https://www.cnlsecurities.com/core/fileparse.php/196/urlt/evaluating-ntbdcs.pdf; Business Development Companies: High Yields, Big Risks?, Schwab, March 4, 2022, https://www.schwab.com/learn/story/business-development-companies-high-yields-big-risks (stating that BDCs charge high fees and lack transparency); Testimony of Mercer E. Bullard, President and Founder, Fund Democracy, Inc. and Butler Snow Lecturer and Professor of Law, University of Mississippi School of Law, before the Subcommittee on Capital Markets, Securities and Investment Committee on Financial Services United States House of Representatives, "Legislative Proposals to Improve Small Businesses' and Communities' Access to Capital," November 3, 2017, https://bit.ly/2LwYKWn. ("One concern is that BDCs are characterized by extremely high fees.").

[10] *See Non-Traded Alts Raise $52 Billion Through May, Stanger Lowers REIT/BDC Sales Projections*, THE DIWIRE.COM, June 27, 2022, https://thediwire.com/non-traded-alts-raise-52-billion-through-may-stanger-lowers-reit-bdc-sales-

The fourth revision recommended in this Notice is to prohibit sponsors from reserving the right to use investor proceeds from an offering to fund regular cash distributions. We agree that funding regular cash distributions through a return of capital is an inefficient use of investor capital and is likely to mislead retail investors into believing they are receiving income when they are not. Restricting sponsors' ability to fund regular cash distributions with investor proceeds would reduce the likelihood of misleading retail investors about the sources of income and would enhance transparency into these products' performance.

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We appreciate your thoughtfulness in proposing these revisions to the REIT Guidelines and urge you to finalize these revisions without undue delay.

Respectfully submitted,

Americans for Financial Reform Education Fund

Better Markets

Consumer Action

Consumer Federation of America

Economic Policy Institute

Public Citizen

U.S. PIRG

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projections/ ("The non-traded BDC space continues its blistering pace of capital formation, up 174 percent from this time last year," said Randy Sweetman, executive managing director of Robert A. Stanger and Co.).