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Via Email: NASAAComments@nasaa.org,
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NASAA
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RE: Proposed Revisions to NASAA Statement of Policy Regarding Real Estate Investment Trusts

Dear Ms. Seidt and Mr. Heuerman:

The University of Miami School of Law Investor Rights Clinic ("IRC") greatly appreciates the opportunity to comment on NASAA's proposal to amend NASAA's current *Statement of Policy Regarding Real Estate Investment Trusts* (REITs) due to the IRC's unique experience representing elderly investors in Florida who would greatly benefit from these retail investor protections. The IRC is a University of Miami School of Law clinical program that represents investors of modest means and net worth who have suffered investment losses by falling victim to broker misconduct, but due to the size of their claims, cannot find legal representation. As the only *pro bono* organization in Florida assisting investors of modest means, the IRC has represented numerous elderly investors in claims regarding non-traded REITs. Based on this experience, which highlights the high potential for harmful sales practices and investor harm, the IRC supports all four of NASAA's proposed revisions to the Statement of Policy Regarding REITs.

Non-traded REITs are a direct investment in registered investment companies formed for the purpose of investing in real estate.[1] Brokers market non-traded REITs as a way to diversify an individual's investment portfolio and gain dividend income,[2] but these investments cause

[1] Brian Henderson, Joshua Mallett, and Craig McCann, *The Journal of Wealth Management Summer 2016,* 19 (1) 84-94, (September 10, 2022) https://jwm.pm-research.com/content/19/1/83.abstract.
[2] *See* Benjamin P. Edwards, *Conflicts & Capital Allocation*, 78:1 Ohio State L.J. 181 at 226 stating that "[s]pokespersons for the interests of non-traded REITs have argued that under [heightened suitability standards] investors could lose their ability to diversify by adding non-traded REITs to their investment portfolios, an unpersuasive argument because retail investors could achieve real estate exposure by buying a publicly traded REIT."; *see also supra* at 189 explaining that investors purchase REITs in general because they are seeking to earn a steady income stream.

harm to those for whom the investment is not suitable.[3] Non-traded REITs are not publicly traded on an exchange. Thus, brokers sell non-traded REITs through direct solicitation, and they pose different risks than publicly traded REITs such as lack of liquidity; high up-front fees; distributions that may come from investor principal; lack of share value transparency; and broker conflicts of interests created by high commissions.[4] Brokers often market non-traded REITs as income-producing investments, even though the distributions paid to investors are often just a return of investors' own principal. For these reasons, non-traded REITs have become a significant cause for concern, and have prompted many commentators, including the IRC, to strongly advocate the need for heightened regulatory scrutiny of the sale of these products.

I. The Investor Rights Clinic's Experience with Non-traded REITs

The IRC has represented several individuals in recent years who have lost considerable savings due to brokers overconcentrating their retirement portfolios in non-traded REITs and other illiquid direct investments. These products are heavily marketed to elderly investors, and the investment objectives of many senior investors conflict with the risk, illiquidity, complexity, and conflicts of interest inherent in non-traded REITs.[5] The IRC's experience illustrates how heightened regulation of non-traded REITs will help safeguard investor funds from the undue risks of these investments and prevent investor confusion regarding the source and nature of non-traded REIT distributions. Three IRC client case studies below demonstrate how the four proposed amendments would increase transparency of the features of non-traded REITs and limit the harm caused to vulnerable investors.

II. Investor Stories Highlighting the Need for Further Regulation of Non-Traded REITs

In one case, a broker approached a 62-year-old retired educator with deteriorating health issues, through a "free lunch" in her community. The broker later went to the client's home and falsely assured her that she would receive six to eight percent in annual income, and that she would be able to liquidate her investment in the non-traded REITs for the full principal amount in 18 to 24 months. Although she clearly communicated to the broker that her primary goal was to safely supplement her Social Security income to afford medical insurance and other necessities, the broker recommended that she invest \$50,000 in two different non-traded REITs in April 2014, another \$20,000 in a non-traded REIT in July 2014, and another \$25,000 in a non-traded REIT in April of 2015. This amounts to \$95,000 out of the \$270,000 she had invested, which means 35 percent of her liquid net worth was concentrated in non-traded REITs. Further,

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[3] *See infra* case examples of IRC clients who were sold non-traded REITs not suitable with their investment profile and suffered considerable losses.

[4] U.S. Securities and Exchange Commission, *Investor Bulletin: Non-traded REITs,* published August 31, 2015, (September 10, 2022), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_nontradedreits.html.

[5] North American Securities Administrators Associationm Inc., Request *for Public Comment: Proposed Revisions to NASAA Statement of Policy Regarding Real Estate Investment Trusts,* (July 12, 2022) at 4.

the broker had overconcentrated $220,000 out of her $270,000—or 81 percent of her liquid net worth—in non-traded REITs and Business Development Corporations ("BDCs"), another type of direct investment. When our client tried to liquidate her non-traded REITs two years later, she learned that no public market existed for these investments. Over the next two years she would also come to know that her "dividend" payments were merely a return of her own principal. She later sold the non-traded REITs for a fraction of the price per share that she paid for them. The broker and his firm, meanwhile, earned seven percent in commissions from each non-traded REIT sale.

In another IRC case, a broker invested the retirement savings of a retired couple into risky, illiquid investments, including two non-traded REITs and other illiquid direct investments. The couple had high school educations and no previous financial education, training, or employment background. At the time they met the broker, they had $290,000 in life savings, $55,000 per year in income, and their only other financial asset was their home. The broker represented non-traded REITs as safe and secure investments that could raise their annual returns from four percent to seven percent. The broker sold all of their diversified, fixed-income mutual funds and invested nearly 70 percent of their life savings into two non-traded REITs and three BDCs. These products were high-risk and the distributions came from the couple's principal—not investment earnings. The broker also failed to notify the couple of the large commissions and upfront costs of the non-traded REITs. The upfront costs for each of the two non-traded REITs were 10 percent, including seven percent in commissions to the broker and his firm. Once the couple realized the true nature of these products, they cut ties with the broker and moved their assets to a new brokerage firm, but the new brokerage firm would not accept the non-traded REITs or BDCs so they began the long and arduous process of selling the products via a secondary market auction broker. In the end, they lost 20 percent of their life savings.

The final IRC client, a 59-year-old widow, had recently become disabled and lived on unemployment insurance, having recently lost her job due to difficulties managing her disability. After her husband's passing, our client was left with almost no income, no family to support her, and modest savings to fund her living expenses for the duration of her life–much of which was inherited from her late mother and husband. The broker then purchased multiple unsuitable and risky investments, including a non-traded REIT. Our client had assets of approximately $180,000, and the broker invested $50,000, or 28 percent, of our client's liquid net worth, in one non-traded REIT. A few short months after the broker placed our client in multiple illiquid investments, she became concerned about volatility in the stock market and requested that the broker liquidate the non-traded REIT. This is when our client learned for the first time that she was not able to liquidate her shares, due to the lack of a public market. Unfortunately, our client was not able to sell her shares until over five years later, after the issuer offered a limited buy back. When the shares were eventually sold, our client lost 32 percent of her principal, while the broker earned a 7.5 percent commission on the product, almost $3,800 for a one-time sale.

III. IRC's Support of NASAA's Proposals

The harm experienced by these three clients of the IRC illustrates how NASAA's four proposals would directly protect at-risk investors—including seniors—from forfeiting a significant portion of their hard-earned savings to the risks of non-traded REITs. These protections are especially important to restrict the sale of non-traded REITs when they are unsuitable for investors' objectives; they do not have the financial means to sustain significant losses or forgo access to principal; or when they misunderstand the true nature of income payments which are not derived from income or profits of the REIT, but are merely a return of their own principal.

a. NASAA's Proposed Conduct Standards Adjustment

The conduct standards adjustment of NASAA's proposal will enhance the standard that governs conduct for brokers selling or recommending non-traded REITs.[6] Enhancing the conduct standards for brokers selling non-traded REITs from the previous suitability standard to the new Regulation Best Interest ("Reg BI") standard will impose new obligations on brokers that are critical to protect investors.[7] Since commissions paid to brokers for sales of non-traded REITs are often much higher than other investments, broker conduct rules under Reg BI will not only require that brokers disclose or mitigate any such conflicts of interest created by commission incentives, but will also require that brokers altogether forgo recommendation of non-traded REITs when it is not in their customers' best interest.[8] More specifically, adding "liquidity needs" to required Know Your Customer information will better protect investors—like clients of the IRC—who learn years after the purchase of a non-traded REIT that no public market exists for their shares.[9] Requiring brokers to explicitly address and document liquidity needs prior to the sale of a non-traded REIT will better inform purchasers of the nature of these investments, and will discourage brokers from omitting critical risk factors relevant to investors' best interests. In all three of the above examples of IRC clients, the illiquidity of non-traded REITs directly harmed our clients. Retirees often need access to their principal in case of emergencies or to supplement cash flow. Furthermore, the illiquid nature of non-traded REITs also leads to significant losses of principal with secondary-market sales being the only viable option for investors to access their principal.[10] The higher broker conduct standards proposed by NASAA will help to curtail some of the harms caused to inventors, partly by discouraging the sales of these products when not in the best interest of a particular investor, and partly by ensuring that brokers must explicitly document Reg BI standards and risks which may better inform investors who choose to proceed with the purchase of a non-traded REIT.

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[6] *Supra* note 5 at 2.
[7] *Supra* at 12 (elaborating on policy statement "III.C.I." of Reg BI that will require brokers not to place their own financial interests above those of a client.)
[8] *Supra* at 5-6.
[9] *Supra* at 6.
[10] *See* Grant H. Frazier & Sarah K. Deutsch, *A Sleight of Hand: Why Non-Traded Real Estate Investment Trusts are Becoming an Increasingly Frequent Subject of Securities Litigation and Arbitration*, 1:2 Corporate Business L.J. 23 (June 2020) at 25, explaining that non-traded REITs are required to be liquidated or listed on a national securities exchange at the conclusion of a specific term designated by the REIT, and if sold prior to the conclusion of this timeframe, there is no primary market for these investments, "Rather, riskier secondary markets are the only avenue for selling such investments – typically at a fractions of the investments' cost."; *See supra* at 42, explaining further that the illiquidity risk further exacerbates the market/return risk of principal invested: "sale upon the secondary market is likely to yield only pennies on the dollar invested."

b. NASAA's Proposed Income and Net Worth Adjustment

The proposed income and net worth adjustments are necessary to maintain the investor protections that existed when the previous figures were adopted in 2007, accounting for inflation over the past 15 years.[11] While the IRC strongly supports this proposed measure, it also notes that income and net worth criteria will continue to be subject to inflation even after adoption of NASAA's proposed model rule. To maintain adequate investor protections, the IRC urges NASAA to consider a rule referencing inflationary figures for the current year as published by the Bureau of Labor Statistics, and referencing NASAA's announcement of the new net worth and income figures for the current calendar year, which can be announced on an annual basis by incorporating the official rate of inflation. As proven by the current amendments, periodic changes of the model rules to account for inflation may be challenging, costly, and time consuming. Since inflation is inevitable and these figures are invaluable in protecting a vulnerable group of potential investors, we believe the appropriate course of action would be to build in this inflationary protection going forward, rather than waiting for the protection to dissipate via inflation and later following up with subsequent regulatory action. In all three cases of IRC clients referenced above, the clients' income and/or liquid net worth would fall below the new threshold proposed by NASAA, which would have made the non-traded REIT investments ineligible to be sold to these harmed investors, and thus could have prevented the loss of their limited retirement funds.[12]

c. NASAA's Proposed Concentration Standard

NASAA's proposed concentration standard addresses the liquidity and market risk inherent in non-traded REITs by setting a maximum threshold of all direct participation investments at 10 percent of an investor's liquid net worth.[13] While 20 states currently have concentration limits in place, this proposal would encourage states to implement uniform investor protection standards across the U.S. by not only encouraging those states with existing concentration standards to meet this minimum threshold, but also by encouraging the majority of states with no existing concentration protection to implement one. The 10 percent threshold proposed is appropriate in light of the speculative and illiquid nature of most direct participation investments, and the typical investor profile that brokers target to purchase these products. As the Request for Public Comment states, there has been no attendant decrease in REIT mismatches or REIT customer complaints since the implementation of Reg BI.[14] Furthermore, the COVID-19 pandemic exacerbated—and simultaneously highlighted—the illiquidity of non-traded REITs when the majority of issuers unilaterally halted redemption programs, denying investors access to principal.[15] Not surprisingly, in all three of the client examples detailed above, the percentage

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[11] *Supra* note 5 at 2.
[12] The three case studies had liquid net worth of $270,000, $290,000, and $180,000 respectively.
[13] *Supra* note 5 at 3.
[14] *Supra* at 7.
[15] *See Non-traded REITs Limit Withdrawals Amid Investor Rush To Retrieve Cash: Smaller Investors Feeling The Financial Pressures From The Pandemic Are Finding It Increasingly Difficult To Redeem Shares*, The Real Deal (Apr. 15, 2020), https://therealdeal.com/2020/04/15/non-traded-reits-limit-withdrawals-amid-investor-rush-to-retrieve-cash/ stating "[m]any fund managers are limiting how much cash investors can pull from their funds, or are refusing withdrawals altogether."

of liquid net worth allocated toward non-traded REITs and other direct participation programs greatly exceeded 10 percent of their liquid net worth.[16] A uniform concentration threshold limiting the sale of these products would have limited or prevented the harm caused to the IRC's clients. But more importantly, this threshold will prevent future harm to investors, who may not understand the risks of non-traded REITs and are often unable to bear the consequences of these risks, as many of the targeted clients for these investments are unsophisticated investors and elderly retirees with no prospect of future earnings.[17] The proposed concentration limit would also reduce the incentives for brokers to recommend large purchases of non-traded REITs for the purpose of generating greater commissions.[18] The 10 percent concentration standard reduces the risk to investors by limiting their exposure to high-risk, illiquid investments.

d. NASAA's Proposed Prohibition of Gross Offering Proceeds as Distribution Source

Investors commonly understand "income" to signify dividends or interest generated by the funds invested—not a return of their own investment principal.[19] The new proposed rule would prohibit issuers of non-traded REITs from using gross offering proceeds—the funds investors have contributed to purchase their shares of the REIT—to make "income" payments to those investors except as a one-time "liquidating distribution" of proceeds.[20] Even if issuers use this one-time "liquidating distribution", the IRC believes that investors should be notified that this feature has been invoked explicitly and contemporaneously with their monthly statements[21] in a form sufficient to ensure that the average investor understands that there is a return of

[16] The three case studies had 35%, 33%, and 28% of their liquid net worth invested into non-traded REITs.
[17] Barbara Black, *Curbing Broker-Dealers' Abusive Sales Practices: Does Professor Jensen's Integrity Framework Offer a Better Approach?*, 48 Wake Forest L.Rev. 771 at 778, explaining that "[b]oth FINRA and State Attorneys General have brought enforcement actions against broker-dealers for abusive practices in the sale of non-traded REITs to unsophisticated investors."

[18] *See* U.S. Gov. Publishing Office, *Putting Investors First? Examining The SEC's Best Interest Rule*, Hearing before the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets of the Committee on Financial Services U.S. House of Representatives, Serial No. 116-10 at 84, explaining that "[b]ecause certain classes of investments (e.g., non-traded REITs . . .) offer significantly higher compensation than other classes of investments . . .the rep has a strong financial incentive to advise the customer to invest in higher-cost, less liquid investments that typically offer the most generous compensation"; *See supra* at 113, "it is unquestionably the case that the higher compensation provided by these products largely explains why they feature so prominently in stories of abusive sales practices."; *See also* Grant H. Frazier & Sarah K. Deutsch, *A Sleight of Hand: Why Non-Traded Real Estate Investment Trusts are Becoming an Increasingly Frequent Subject of Securities Litigation and Arbitration*, 1:2 Corporate Business L.J. 23 (June 2020) at 27, stating "investment firms have suffered significant fines for purchasing more Non-Traded REITs than allowed in keeping an asset allocation suitable for their clients' portfolios."; *See also supra* Grant H. Frazier & Sarah K. Deutsch, at 37-38, stating that "[g]iven the common characteristics of Non-Traded REITs (most importantly, their illiquidity), loading up a client with a number of Non-Traded REITs does not constitute diversification of a portfolio, and such a situation would likely not meet Investment Professionals' suitability standards."

[19] *See Dividend,* Merriam-Webster Dictionary, https://www.merriam-webster.com/dictionary/dividend, defining a dividend as "an individual share of something distributed, such as a share in a pro rate distribution (as of profits) to stockholders; a resultant return or reward."
[20] North American Securities Administrators Association, Inc. *Request for Public Comment: Proposed Revisions to NASAA Statement of Policy Regarding Real Estate Investment Trusts,* July 12, 2022 at 9.
[21] *Supra.*

principal in plain English and work to mitigate brokers falsely marketing non-trade REITs as "income-producing."

Including disclaimers regarding the source of distributions in the fine print of the prospectus has proven insufficient as a solution to this problem[22] for two reasons. First, the prospectuses of non-traded REITs are often several hundred pages long, and these disclosures are simply not read by the average investor. Second, investors may not understand the distinction or its significance. Brokers may even be reluctant to explain this to unsophisticated investors due to high commissions they can receive from selling non-traded REITs.[23]

The IRC supports the prohibition of non-traded REITs adopting a policy or practice of sourcing distributions from gross offering proceeds. These practices are not only misleading and confusing to investors, but they also dilute the principal value of the subject investment without the investor's informed knowledge and consent. All of the IRC clients referenced above were not aware that their "income" payments were actually returns of their own principal, despite ineffective disclosures.

IV. Conclusion

The IRC supports all four proposed revisions by NASAA and encourages NASAA to consider implementing a built-in inflationary protection to the income and net worth guidelines to protect investors' interest going forward without the need for further regulatory action. NASAA's four proposals would implement concrete parameters for recommendations of non-traded REITs and will encourage more transparent practices of brokers who choose to sell these investment products, thus enhancing investor protection. If NASAA's four proposals had been implemented at the time our clients invested in non-traded REITs, none of the three retirees illustrated above would have met these improved best interest requirements, and the brokers would not have been permitted to sell them non-traded REITs. In summation, the IRC supports all the proposed revisions and thanks NASAA for providing the opportunity to comment on this important issue.

Respectfully,
/s/ *Scott Eichhorn*
Scott Eichhorn
Acting Director

/s/ *Alexandra McHugh*
Alexandra McHugh
Student Intern

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[22] *See* FINRA Top 15 Controversy Types, https://www.finra.org/arbitration-mediation/dispute-resolution-statistics#top15securitycustomers, illustrating that REITs had the highest number of FINRA arbitration cases in 2020, as compared to all other investment types.

[23] *See supra* note 2 at 188, explaining that product features of non-traded REITs are often concealed or explained to investors in a convoluted way, and further stating that "[n]on-traded REITs appear cynically designed to make it possible for financial intermediaries to advance their own interests at the expense of their clients."

/s/ *Seth Maack*
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Student Intern

/s/ *Kristy O'Malley*
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