



## PUBLIC INVESTORS ADVOCATE BAR ASSOCIATION

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September 12, 2022

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North American Securities Administrators Association, Inc.  
Andrea Seidt, Section Chair  
Mark Heuerman, Project Group Chair  
750 First Street NE, Suite 990  
Washington, DC 20002

Re: PIABA Comments to Proposed Revisions to NASAA Statement of Policy  
Regarding Real Estate Investment Trusts (REITs)

Dear Ms. Seidt and Mr. Heuerman:

I write on behalf of the Public Investors Advocate Bar Association (“PIABA”), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority (“FINRA”) and model rules and policies promulgated by the North American Securities Administrators Association, Inc. (“NASAA”) relating to both investor protection and disclosure. As such, PIABA frequently comments upon proposed rule changes, retrospective rule reviews, and policy matters to protect the rights and fair treatment of the investing public.

PIABA supports each of the four proposed revisions to the NASAA *Statement of Policy Regarding Real Estate Investment Trusts* (the “REIT Guidelines”).

FINRA has long recognized and warned its member firms that complex products, such as non-traded REITs with their unique essential characteristics and corresponding risks, may be difficult for retail investors to understand. Accordingly, FINRA advises its member firms to apply heightened supervision for complex products, to implement comprehensive training for registered representatives, and to periodically

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assess the particular complex product and whether a less complex product would achieve the same result.<sup>1</sup> With the application of Regulation Best Interest (“Reg BI”), as well as the fiduciary obligations of investment advisers, FINRA and the SEC have emphasized the importance of understanding the key terms, features, and risks of complex products so that the broker can establish, at a minimum, a reasonable basis to recommend the product to a particular retail customer and the investment adviser can meet their federally-mandated fiduciary obligations.<sup>2</sup>

FINRA notes that such concerns can be even greater when a retail customer is purchasing complex products through a self-directed platform without the benefit of a broker or investment adviser to explain the risks and features of the product in light of the customer’s investment objectives and risk tolerance.<sup>3</sup>

Non-traded, unlisted REITs can create significant liquidity and valuation issues for retail investors. Effective April 11, 2016, FINRA significantly changed its then-Rule 2340 (Customer Account Statements) and provisions addressing per share estimated valuations for unlisted direct participation programs (“DPPs”) and REITs.<sup>4</sup> This changed the long-standing industry practice of using the offering price (typically \$10 per share) of DPPs and REITs as the per share value on account statements during the offering period of that security, which could be as long as seven and a half years. This practice created a misleading representation of the current value of these securities, and a false impression of stability, sometimes for years on a customer’s account statement. PIABA noted in its comment letter that curbing misleading sales and reporting practices during the early stages of DPP and REIT offerings was a critical investor protection issue.<sup>5</sup>

Just as accurate, reliable valuation information about share value is critical, so is the long-recommended heightened supervision of sales of non-traded DPPs and REITs. PIABA supports NASAA’s efforts to review and modernize its Statement of Policy in light of Reg BI and other current considerations.

### **(1) Updating REIT Guidelines to Recognize Reg BI**

This proposed revision is a practical housekeeping update – formally incorporating the guidelines of Reg BI, which became effective June 30, 2020 – as well as any other updated conduct standard adopted by applicable NASAA jurisdictions. There should be no controversy regarding this update.

### **(2) Update Net Income and Net Worth Figures Upward to Account for Inflation**

This proposed revision is another practical update – adjusting figures last updated on May 7, 2007, to account for the last 15 years of upward inflation. PIABA generally supports periodically revisiting all guiding net income / net worth figures in the context of their investor protection purpose, recognizing the

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<sup>1</sup> See FINRA Regulatory Notices 22-08 and 12-03.

<sup>2</sup> *Id.*

<sup>3</sup> See FINRA Regulatory Notice 22-08.

<sup>4</sup> SR-FINRA-2014-006. Proposal and key documents available at: <https://www.finra.org/rules-guidance/rule-filings/sr-finra-2014-006>.

<sup>5</sup> PIABA Comment Letter dated June 24, 2014, available here: <https://piaba.org/piaba-newsroom/comment-letter-sr-finra-2014-006-order-instituting-proceedings-determine-whether>.

changing value of a dollar over time. The adjustments proposed by NASAA, based on the U.S. Bureau of Labor Statistics Consumer Price Index for All Urban Consumers, is reasonable and appropriate.

### **(3) Concentration Limits**

PIABA appreciates NASAA addressing the current and documented problem recognized by FINRA: that despite over two years since Reg BI's implementation, many broker-dealer firms have still not materially changed their policies, practices, or procedures regarding the sale of complex products including non-traded REITs.<sup>6</sup> As noted in NASAA's explanation of the proposed revisions to the REIT Guidelines, many state securities regulators have independently imposed concentration limits regarding the maximum amount a retail investor may invest in non-traded REITs offered in their jurisdiction. Generally speaking, uniformity across the states would help curb investor confusion and improve regulatory compliance on this topic.

NASAA recommends a limitation prohibiting an aggregate investment in the issuer, its affiliates, and other non-traded DPPs or REITs that exceeds 10% of the purchaser's liquid net worth. *Liquid* net worth, defined as cash, cash equivalents, and marketable securities, is critical here. One of the key concerns about these complex products is that they are *not* traded on an open market, and thus the ability to liquidate may be nonexistent or provide mere pennies on the dollar in a secondary market. Tying up a large percentage of liquid net worth in non-traded securities can be devastating for an investor, especially for retirees seeking regular income from their investments, but who may experience sudden, unanticipated liquidity needs. Sales of unlisted DPPs and REITs for retirement accounts can be particularly harmful to an investor who must take out required minimum distributions or face significant tax penalties.

Industry concerns that this concentration limitation would somehow *harm* retail investors by limiting access to DPPs and REITs is unfounded. For the retail investor appropriately seeking further diversification in so-called "alternative investments," there are many types of complex products other than unlisted DPPs and REITs for consideration. Ultimately, the mission of the SEC and state securities regulators is investor protection and integrity of the markets, not padding the pocketbooks of issuers of unlisted DPPs and REITs and those who sell their products.

### **(4) Prohibition to Issuers Using Gross Offering Proceeds to Pay Distribution Sources**

As noted above, in 2016, FINRA changed its rule regarding permissible valuation methods for reporting unlisted DPP and REIT shares on customer account statements. NASAA's proposal to prohibit sourcing regular distributions from gross offering proceeds (creating phantom "yields" that are not clearly disclosed in a price adjustment to investments) and related proposed changes are consistent with investor protection objectives.

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<sup>6</sup> See NASAA Reg BI Phase IIA Report (Nov. 2021), available at: [https://www.nasaa.org/wpcontent/uploads/2021/11/NASAA-Reg-BI-Phase-II-A-Report-November-2021\\_FINAL.pdf](https://www.nasaa.org/wpcontent/uploads/2021/11/NASAA-Reg-BI-Phase-II-A-Report-November-2021_FINAL.pdf); see also 2022 Report on FINRA's Examination and Risk Monitoring Program (February 9, 2022), available at: <https://www.finra.org/rules-guidance/guidance/reports/2022-finras-examination-and-risk-monitoring-program>.

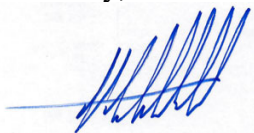
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Non-traded DPPs and REITs are regularly described as “stable” and “fixed-income” investments and sold as income-producing investments to diversify the fixed income portion of a portfolio. The dangers of marketing phantom “yield” for securities that engage in this practice of distributing gross offering proceeds are significantly high. This is particularly true for the most vulnerable investors relying on steady income in retirement and without the benefit of long-time horizons to recover from industry declines.

Further, mere disclosure of the practice – suggested as an alternative to prohibition – is insufficient for meaningful investor protection. Given the documented industry failures to implement disclosure requirements under Reg BI, there is little confidence that a mere disclosure would be meaningfully explained to investors, let alone implemented, by the industry in this area.

We thank you for the opportunity to comment on the proposed revisions to the REIT Guidelines and encourage NASAA to continue to be a leader in proposed rules and guidelines for state securities regulators in matters impacting protection of retail investors.

Sincerely,



Michael Edmiston, President  
Public Investors Advocate Bar Association