August 11, 2022

Andrea Seidt, Esq.
Ohio Securities Commissioner
Ohio Department of Commerce
77 South High Street
Columbus, Ohio 43215

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

Dear Commissioner Seidt,

Thank you for NASAA's continued efforts on behalf of investors and for giving careful consideration to the regulatory framework for the sale of nontraded real estate investment trusts. You see the harm to residents in your States from aggressive sales of nontraded REITs each week. My research described below documents that this widespread harm.

By way of background, I am a former academic and government economist; for nearly thirty years I have been a consultant in securities matters for individuals, corporations and state and federal agencies. I have published approximately 65 working papers, more than 30 of which have appeared in peer-reviewed journals. I have studied nontraded REITs for ten years. With coauthors, I have published two in-depth empirical papers and two additional comments on the returns earned by investors in nontraded REITs in peer-reviewed journals.[1] Our research is the only complete and accurate compilation of returns earned by investors in nontraded REITs. I briefly summarize our findings next as they inform my comments on NASAA's Proposed Revisions offered further below.

Returns to Investors in Nontraded REITs

In our 2015 paper, "An Empirical Analysis of Non-traded REITs", we documented that investors were at least $44 billion worse off as a result of investing in the 89 non-traded REITs compared to investing in a diversified portfolio of traded REITs as of May 1, 2015. More than half of the non-traded REITs' underperformance resulted from $15 billion in upfront fees charged to investors in offerings - fees that have grown to approximately $25 billion by the time the traded REITs became traded or last updated their NAVs prior to May 1, 2015. The rest of the non-traded REITs' underperformance results from conflicts of interest which permeate the organizational structure of non-traded REITs and which are largely absent in traded REITs.

[1] *See* "Fiduciary Duties and Non-Traded REITs" Investments & Wealth Monitor July/August 2015; "An Empirical Analysis of Non-traded REITs", with Brian Henderson and Joshua Mallett, Journal of Wealth Management, 19(1): 83-94, Summer 2016; "Further on the Returns to Non-traded REITs", with Joshua Mallett, *Journal of Wealth Management*, 24(3): Winter 2021; "Further on the Returns to Non-traded REITs: A Reply", with Regina Meng, *Journal of Wealth Management*, Fall 2022. My resume can be found at www.slcg.com/files/resumes/craig-mccann.pdf.

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In our 2021 paper, "Further on the Returns to Non-traded REITs", we updated our 2015 study including 51 nontraded REITs that came into existence after May 1, 2015 and either had had a liquidity event or updated their NAVs between May 1, 2015 and December 31, 2019. We documented that returns to nontraded REITs continued to fall substantially short of the returns to traded REITs. For all 140 nontraded REITs, the shortfall relative to traded REITs was at least $59.2 billion. This systematic underperformance is observed for nontraded REITs whether launched before or after May 1, 2015. Nontraded REITs' returns were lower than traded REIT returns for capital raised by nontraded REITs in every calendar quarter.

It required extraordinary effort to document the nontraded REIT returns we report in our research papers because nontraded REITs raise money over extended offering periods rather than in discrete offerings and because nontraded REITs do not have observed market prices. In our work, we used actual cash paid by investors for shares and cash distributions and redemption or sales proceeds received. For nontraded REITs that listed or were acquired by a listed REIT, we used the closing price on the first day the nontraded REIT investor could sell a listed share. For REITs still operating as a nontraded REIT, we calculated returns using both the nontraded REITs' reported NAV and their reported NAVs discounted to reflect illiquidity.

Industry Comment on our Research

There has been no serious challenge to our $59.2 billion harm to investors resulting from investing in nontraded REITs versus investing in traded REITs. The industry comments on our work which I have observed over the years – some of which may find their way into comments on NASAA's Proposed Revisions – have been uninformed, unsubstantiated and often *ad hominin*. Giving the devils their due, variations on the following two criticisms of our work have been offered by the industry.

Asset Returns versus Investor Returns, Appraisals versus Transactions

The direct participation program trade association sponsors a quarterly publication which purports to measure the returns to nontraded REITs. This marketing publication measures returns based on the REITs' NAVs. All but the most sophisticated readers of this publication may be easily confused and believe that publication is reporting returns earned by investors. Instead, it reports returns at the underlying property level based on appraisals.

Investors have historically bought nontraded REIT shares at approximately 15% above NAV and often sold shares at substantial discounts to NAV. In recent years some sponsors have launched NAV REITs which provide greater liquidity and lower costs. Nonetheless, adjusted for inflation, 9**X**% of all nontraded REIT sales have been extremely illiquid "lifecycle" REITs and only **X**% have been NAV REITs.[2]

The trade association's publication dramatically overstates the returns earned by investors because of a) high offering costs charged to fund extraordinary sales commissions, b) above market annual expenses arising out of conflicts of interest in the management of nontraded REITs and c) discounts investors accept on some share sales.

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[2] Blackstone Real Estate Investment Trust (BREIT) accounts for the majority of NAV REIT capital raise and a majority of the value of all outstanding nontraded REITs. BREIT does not suffer from many of the pernicious characteristics of lifecycle REITs and NAV REITs offered by sponsors of lifecycle REITs.

COVID Pandemic Returns

Our 2021 published study reported on returns up through December 31, 2019 because we were writing up the results in the first quarter of 2020 with the most recent available data. In a twist on the deceptive industry claim that unobservable market prices reflect lower volatility than traded stocks including traded REITs, one industry advocate recently asserted without analysis or support that our $59.2 billion nontraded REIT shortfall overstated the harm investors suffered because of nontraded REITs performed much better than traded REITs during the COVID pandemic.

As we show in our published Reply, including 2020 and 2021 dramatically *increases* the relative underperformance of nontraded REITs. The shortfall for the 64 REITs operating after May 1, 2015 increases 63% from $20.1 billion as of December 31, 2019 to $32.8 billion as of December 31, 2021 if operating REITs' NAV are not adjusted for illiquidity and 52% from $36.5 billion to $55.5 billion if operating REITs' NAV are adjusted for illiquidity.

NASAA's Proposed Revisions

My comments address three of the four areas of proposed revisions.

Proposed Revision #2 – Income and Net Worth Adjustment

If dollar value thresholds are set to allow or proscribe nontraded REIT sales, they should be adjusted periodically to reflect inflation. Prices have doubled – and the value of $1 halved – since July 1994. Income and net worth thresholds set in 1994 in nominal terms to protect investors by limiting who can be sold certain investments, today would allow sales to investors with only half the income and net worth deemed necessary in 1994.[3]

When inflation is low, revising income and net worth thresholds is less consequential and the regulatory burden may be similar whether inflation is low or high. Thus, you might consider adjusting income and net worth thresholds whenever the CPI has increased 20% since the most recent adjustment to income and net worth thresholds.

Automatic adjustments of thresholds for inflation is, in my opinion, of secondary importance compared to the baseline level at which these thresholds are set and the thresholds and concentration limits discussed next are interrelated. Rather than setting income and net worth thresholds at $95,000, I suggest you consider thresholds for income of at least $100,000 in combination with liquid net worth of at least $500,000 or liquid net worth in excess of $1 million.

Proposed Revision #3 – Concentration Standard

I urge you to adopt a 10% concentration limit on nontraded REITs and other direct participation programs. There will be tremendous benefit to investors generally and no harm to any investor from limiting the concentration in nontraded REITs and other direct participation programs in their portfolios.

Liquid, traded alternatives to nontraded REITs with the same investment exposures are readily available. Nontraded REITs with rare exception are simply a vehicle created by the securities industry to extract some significant portion of your residents' wealth. By my estimation, the

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[3] I use July 1994 to illustrate the issue because cumulative inflation has been 100% since then but the same principal applies over any time period. Inflation lowers the value of $1 and erodes the meaningfulness of nominal dollar thresholds. Calculated using https://www.bls.gov/data/inflation_calculator.htm. Inflation has been 204% since July 1994, 100% since July 1994 and 42% since May 2007.

industry has been able to extract at least $70 billion that should be in the accounts of residents of your States.

I strongly urge the adoption of a 10% concentration limit on the sale of nontraded REITs and other direct participation programs. As a researcher and investor advocate, I believe a 5% limit would be better than a 10% limit and that a 1% limit would be better than a 5% limit.

My strong opinion on the importance of a 10% concentration limit is not only because of the $70 billion in harm already suffered by investors in baleful nontraded REITs. Fundamentally, in a diversified portfolio, assets are held in proportion to their market capitalization. Differences in portfolio asset allocations from the ratio of an asset's market capitalization to the market capitalization of all investable assets are thus a measure of departures from diversification.

On December 31, 2021, the market capitalization of US stocks was $53.765 trillion and the value of US household financial assets were $117.722 trillion while the market capitalization of traded REITs was approximately $1.768 trillion and the market capitalization of nontraded REITs was $0.102 trillion.

Table 1 uses this simple data to provide estimates of how much of a diversified portfolio would be invested in nontraded REITs, traded REITs and all REITs. Nontraded REITs are only 0.09% of US households' financial assets and only 0.19% of US listed stocks. Limiting the industry to putting no more than 10% of a resident's liquid net worth into nontraded REITs would still allow for 50 to 100 times more nontraded REITs to be sold to a resident as would be held in a diversified portfolio.

Table 1 Implied Asset Allocations for Nontraded and Traded REITs ($ in trillions).

		US Listed Stocks	Household Financial Assets
		$53.765	$117.722
Nontraded REITs	$0.102	0.19%	0.09%
Traded REITs	$1.768	3.29%	1.50%
All REITs	$1.870	3.48%	1.59%

For reasons I detail in my peer-reviewed publications, traded REITs are far superior to nontraded REITs. Traded REITs could be sold to a resident if a 10% concentration limit on nontraded REITs was binding and the brokerage firm had good reason to recommend more real estate exposure to that resident.

Proposed Revision #4 – Gross Offering Proceeds Prohibited as Distribution Source

I urge you to prohibit the systematic use of offering proceeds to fund distributions.

Nontraded REITs have been sold in part based on distributions that looked like bond coupons without regard to the cash flow generated by the REITs' portfolio holdings. For instance, a nontraded REIT would pay $0.15 per share quarterly ($0.60 per share annually) on shares sold for $10 and carried on account statements at $10 even as the REITs had large negative cash flows from operations.

These distributions look like 6% coupon payments and don't reflect the fluctuations in profitability of the REIT portfolio. Combined with the near constant account statement values and

lack of trading activity, these distributions divorced from profitability mislead investors into believing that nontraded REITs are much less risky than traded REITs and other common stock. In addition, since substantial offering costs including commissions are deducted from gross offering proceeds before cash is invested or distributed out, funding distributions from gross offering proceeds simply returns capital to investors after a large deduction.

Of course, cash is fungible. Sponsors may find a way to evade the intent of the proposed prohibition by funding distributions with debt which they subsequently pay off with gross offering proceeds. Alternatively, they may cycle gross offering proceeds briefly through property holdings and use the sale of these short-term property holdings to fund distributions. A requirement that nontraded REITs not over distribute their income or cashflow by more than 20% across any two consecutive years would accomplish your goal with less opportunity for mischief.

Conclusion

Thank you for giving me an opportunity to comment on your Proposed Revisions. I focused on the 2nd, 3rd and 4th of your proposed revisions.

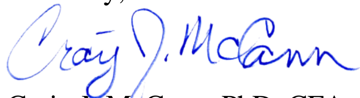
Income and net worth thresholds for the sale of nontraded REITs should be adjusted periodically for inflation. The thresholds should be set at much higher levels than the current $70,000 and $250,000 amounts.

Concentration in nontraded REITs and other direct participation programs should be capped at 10%. Nontraded REITs are currently 0.1% of household financial assets and 0.2% of listed stock market capitalization. No investor needs 50 to 100 times these levels of nontraded REITs in their portfolio. Any investor who would benefit from more concentrated real estate exposure, should invest in traded REITs which provide lower costs, higher returns and greater liquidity.

Nontraded REITs should be prohibited from using gross sales proceeds (and borrowing) to directly or indirectly fund regular distributions. By severing the link between profitability and distributions, the REITs appear more profitable and stable than they are in reality.

Thank you, again, for giving me the opportunity to comment on your proposed revisions.

Sincerely,



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