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DEPARTMENT OF FINANCIAL INSTITUTIONS
SECURITIES DIVISION
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September 9, 2022

Andrea Seidt, Corporation Finance Section Chair
Ohio Securities Commission
Ohio Department of Commerce
77 South High Street
Columbus, Ohio 43215

Mark Heuerman, Direct Participation Programs Policy Project Group Chair
Ohio Securities Commission
Ohio Department of Commerce
77 South High Street
Columbus, Ohio 43215

Subject: Request for Public Comment – Proposed Revisions to the NASAA Statement of Policy Regarding Real Estate Investment Trusts

Dear Ms. Seidt and Mr. Heuerman:

The Washington State Securities Division ("Division") has reviewed the proposed amendments to the NASAA Statement of Policy Regarding Real Estate Investment Trusts ("REIT Guidelines"), and appreciates the opportunity to comment on this important proposal. The Division thanks the Direct Participation Programs Policy Project Group ("Project Group") for its hard work.

The Division writes to express its strong support for the amendments as proposed, and we appreciate the creation of uniform standards to address issues that NASAA members have consistently highlighted or otherwise attempted to address on an individual basis. We believe that industry and NASAA members alike will benefit from the increased efficiency that accompanies increased uniformity.

We further believe that these proposals must be adopted to ensure that today's investors are adequately protected against the significant risks that accompany an investment in a non-traded real estate investment trust ("REIT"). The risk that investor may be locked into a non-traded REIT that presents higher costs, involves significant conflicts of interest, and provides limited say in the affairs of the company[1] has remained constant – regardless of how features of this investment have

[1] We note that underlying state corporate governance laws appear to provide only limited protection to investors. Non-traded REITs are typically organized under Maryland law, which: (i) requires a minimum of only one director serve on the board (which could result in one individual approving conflicted transactions and material agreements or

evolved over time. For this reason, and the reasons we set forth below, we believe that it is imperative to adopt these proposals to ensure that such risks are appropriately addressed in the interest of investor protection.

The Proposed Amendments Ensure that the REIT Guidelines Stay Current and Promote Uniformity.

The Division wishes to express strong support for the proposed amendments, as they appropriately capture developments that have occurred since the REIT Guidelines were last amended. We further believe that uniform standards to address these developments will provide enhanced investor protection and ease of administration for industry participants.

In particular, the Division supports the inclusion of other applicable conduct standards that may apply to the sale or recommendation of a REIT's shares. These amendments appropriately reflect the evolution of federal and state conduct standards since the REIT Guidelines were last amended.

The Division also wishes to express strong support for the proposed adjustments to income and net worth standards for inflation. These income and net worth thresholds, which seek to ensure that investors can adequately bear the risk of loss, are not a new feature. However, the thresholds have remained stagnant since 2007, and as such have swept in potential investors who stand in a very different financial position to those envisioned when the REIT Guidelines were last amended. The proposed adjustments ensure that this important protective feature stays current.

We further believe that the proposed amendments will promote uniformity on issues that NASAA members have sought to address on an individual basis. In the absence of inflationary adjustments, certain jurisdictions have required that their residents meet higher income and net worth standards in order to invest in a non-traded REIT. Others have imposed concentration limits, with certain jurisdictions requiring concentration limits substantially similar to those proposed. We believe that industry participants will be able to adapt their current practices to comply with these proposals[2],

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otherwise making certain determinations, unchecked); (ii) permits a corporation to impose unreasonably high bars for the removal of its directors by shareholders, including by a two-thirds vote and only in the event of a felony conviction or judgment finding the director caused material harm through active and deliberate dishonesty; (iii) permits companies to participate in certain types of mergers, consolidations or share exchanges without shareholder approval; and (iv) requires that a board declare charter amendments "advisable" prior to a shareholder vote, *leaving* shareholders unable to take action without board concurrence. The REIT Guidelines build in important shareholder protections, including by requiring a minimum of three directors, each of whom is elected by the REIT's shareholders; allowing a majority of shareholders to remove a director without cause; and prohibiting directors from causing a merger or reorganization of the REIT without concurrence of a majority of outstanding shares. Even with these protections, however, the board of a REIT is empowered to take a number of significant actions without shareholder approval, including revoking or terminating the REIT election; increasing or decreasing number of shares that the REIT has the authority to issue; and changing the REIT's policies with regard to investments, operations, indebtedness, capitalization or distributions at any time. These actions could fundamentally change the nature of a shareholder's investment.

[2] In addition to complying with substantially similar state concentration limits, we note that the REIT Guidelines currently require sponsors and each person selling shares on behalf of the sponsor or REIT determine that the purchase of such is suitable and appropriate for each shareholder, and further provides that relevant information on which to base this determination includes *other investments of the prospective shareholder*. Similarly, federal Regulation Best Interest requires brokers, dealers, and associated persons to have a reasonable basis to believe that a recommendation

and that the implementation of updated uniform standards will further afford ease of administration.

The Proposed Amendments Preserve Important Investor Protection Features and Reflect Fundamental Investor Expectations.

Beyond promotion of uniformity and ensuring that the REIT Guidelines stay current, the Division strongly supports the proposed amendments, as they preserve important investor protection features and reflect fundamental investor expectations.

In particular, the Division supports the express inclusion of associated persons, investment advisers, and investment adviser representatives in the prohibition against indemnification for violations of federal or state securities laws unless certain conditions are met. Proper limits on indemnification prevent an issuer from unduly and unfairly placing the risk of loss on investors; without such, a non-traded REIT may pay expenses to indemnitees at a great loss to funds available for investment or distribution, without consideration as to whether these persons committed misconduct. For this reason, we further support expressly prohibiting indemnification for violations of conduct standards unless certain conditions are met. We note that conduct standards may be imposed by self-regulatory organizations and otherwise relate to serious misconduct, and therefore believe that it is of equal importance that a similar prohibition against indemnification be included in the REIT Guidelines.

In addition, we strongly support the proposed concentration standards. Concentration limits promote portfolio diversification and risk management: these are well-established, common-sense foundations of investing. As non-traded REITs and other non-traded direct participation programs often pose the same risks to investors (limited liquidity[3], high fees and expenses, lack of historical operations), we believe that the proposed concentration limit appropriately protects investors against an exacerbated risk of loss. We further believe that it is important to emphasize that the concentration limit may not be used as a sword to concentrate *up to* ten percent of an investor's liquid net worth in direct participation program interests; concentration limits are no substitute for applicable standards of conduct.

We further urge the Project Group to reject any calls to exclude accredited investors from the proposed concentration standards. By the Securities and Exchange Commission's own admission, its failure to adjust the financial thresholds of the accredited investor definition has effectively *lowered* the thresholds in terms of real purchasing power.[4] As such, concentration standards not

is in the best interest of a particular retail customer based on that retail customer's investment profile – which includes other investments of the retail customer. For this and other reasons, we believe that industry participants will be able to adapt their current practices to comply with these proposals.

[3] In addition to the fact that an investor cannot readily sell their shares on an open market, and that share redemption programs offered by a non-traded REIT can be readily suspended or terminated at the discretion of the board, we note that many non-traded REITs have "opt-out" distribution reinvestment plans ("opt-out DRIPs), whereby investors who do not opt out will have their distributions automatically reinvested in the REIT's shares. This may exacerbate the illiquidity of the investment.

[4] Revisions to Limited Offering Exemption in Regulation D, 72 Fed. Reg. 45115 at 42 (proposed Aug. 3, 2007), available at https://www.sec.gov/rules/proposed/2007/33-8828.pdf.

only promote diversification but also protect investors who have been pushed into the accredited investor definition due to inflation against unaffordable losses or lackluster performance.

As with the proposed concentration limits, we strongly support the prohibition on the use of gross offering proceeds to fund regular distributions. We believe that this practice has the potential to mislead, particularly in light of the fact that non-traded REITs are often touted for their “yields” and “tax-efficient income.”[5] Beyond this, we believe that sourcing regular or declared distributions is fundamentally inconsistent with investor expectations: investors expect that their funds will be put toward accomplishing a company’s business objectives and seek to share in the profits of the company, not have their invested funds simply returned to them. Non-traded REITs and non-traded business development companies appear to be unique in this regard; we are unaware of any other state-registered product that regularly reserves the right to – and does - source distributions from offering proceeds. This feature results in less funds available to acquire properties or other real estate-related investments, may reduce the return realized on the investment, and may also negatively impact cash flows of the REIT.

Thank you for your consideration.

Sincerely,

William M. Beatty
Securities Administrator

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[5] Given the way these products are marketed and presented, we believe that other methods to address this practice are insufficient. We note in particular that the REIT Guidelines already prohibit sales material from containing quantitative estimates of an issuer’s anticipated return to participants, including in the form of tax benefits. We further note that FINRA guidance further prohibits firms from stating or implying that a distribution rate is a “yield” or that an investment in a program is comparable to a fixed income investment such as a bond or note. Yet, we continue to encounter non-traded REIT advertising that touts a favorable “after tax yield” due to changes in tax laws or when compared against wholly distinct investments such as U.S. investment-grade bonds; advertising that indicates favorable tax-deferred savings when the REIT’s distributions are “in excess of the REIT’s earnings or profits”; or advertising that otherwise promotes “tax efficient income.” To the extent that a REIT makes distributions in excess of its earnings and profits, this may constitute a return of capital, or otherwise money that has not been invested and is not income of the REIT. It is understandable that this distinction may be lost on investors, particularly when that non-traded REIT deemphasizes any disclosure that it may pay distributions from any source including offering proceeds, fails to disclose the potential long-term tax consequences associated with a return of capital, or uses an apples-to-oranges comparison of the “after-tax yield” of its shares compared to incomparable investment products. We further note that non-traded REITs already disclose in their registration statements that distributions may be paid out of any source, including offering proceeds, however, these registration statements are often hundreds of pages long and such lengthy disclosure may cloud such important information.