Via electronic submission to NASAAComments@nasaa.org
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September 12, 2022

NASAA Corporation Finance Section
Andrea Seidt, Section Chair
Mark Heuerman, Project Group Chair

c/o North American Securities Administrators Association, Inc.
750 First Street, N.E., Suite 1140
Washington, D.C. 20002

Re: Proposed Revisions to the NASAA Statement of Policy Regarding Real Estate Investment Trusts dated July 12, 2022 (the "Proposal")

Dear Section Members, Commissioner Seidt and Mr. Heuerman:

The Institute for Portfolio Alternatives (the "Institute") welcomes the opportunity to comment on the Proposal. The Institute represents the sponsors and distributors of alternative products, including non-listed REITs and business development companies, interval funds, and tender-offer funds.[1]

The Proposal, if adopted by the states, would dramatically expand state regulation of non-listed REITs, among other investments, and will serve as a template for additional regulation of other products.[2] The Institute and other associations asked NASAA to extend the comment period, and we appreciate NASAA's willingness to do so for another 30 days.[3]

Thank you in advance for considering our comments on the Proposal. The Institute agrees with NASAA concerning the importance of investor protection. We look forward to working with you toward

[1] For more than 35 years, the Institute has advocated for increased investor access to portfolio diversifying investment strategies, accompanied by straightforward disclosure about their risks and benefits and strong investor protection from inappropriate sales practices. Our members include the asset management companies that sponsor diversifying investments, wirehouse broker-dealers, independent broker-dealers, regional broker-dealers, registered investment advisers, law firms, accounting firms, transfer agents, valuation firms, due diligence firms, and technology firms.

[2] "If adopted, these revisions have the potential to influence updates to other sets of Guidelines that are under development, including those for the Omnibus Guidelines, Asset-Backed Securities, Commodity Pools, Equipment Leasing, Mortgage Programs and Real Estate Programs (other than REITs). These updates will also permit the NASAA Business Organizations and Accounting Project Group to move forward with its proposal for inaugural guidelines applicable to business development companies." https://www.nasaa.org/wp-content/uploads/2022/07/Request-for-Public-Comment-on-Amendments-to-NASAA-REIT-Guidelines-2022.pdf.

[3] Letter to NASAA Corporation Finance Section, Commissioner Andrea Seidt and Mr. Mark Heuerman, August 2, 2022, available at https://www.ipa.com/wp-content/uploads/2022/08/Joint-Letter-to-NASAA-Extension-Request.pdf.

that goal while preserving access to portfolio diversifying investments that are in the best interests of many retail investors.

Summary of our Comments

The Institute strongly opposes and recommends withdrawal of the Proposal for several reasons as set forth below:

- *The Proposal Attempts to Address Concerns that the Market has Already Addressed.* The Proposal confuses legacy lifecycle REITs with public, non-listed REITs that continuously offer and regularly repurchase their shares at net asset value ("NAV REITs") – virtually the only non-listed REITs offered today.[4] The Proposal would add requirements to the existing NASAA Statement of Policy regarding Real Estate Investment Trusts (the "Guidelines"), but the Guidelines – adopted over 25 years ago and never significantly updated – are already out of alignment with the structure and operation of non-listed REITs.[5] NAV REITs differ from legacy lifecycle REITs that are the focus of the Proposal. NAV REITs offer better liquidity through share repurchase programs and pay lower advisory fees and selling compensation to sponsors and broker-dealers. NAV REITs held up well during the pandemic: NAV REITs representing over 97% of all raised funds satisfied all of their stockholders' redemption requests. NAV REITs are heavily regulated on the federal level by the United States Securities and Exchange Commission ("SEC") and the Financial Industry Regulatory Authority ("FINRA"), as are the investment advisers and broker-dealers that recommend these products.[6] NASAA does not acknowledge any of the differences between the two different forms of non-listed REIT.

[4] In 2020, a total of approximately $10.9 billion was raised for non-listed REITs, about 98.9% of which was raised for NAV REITs. In 2021, capital raising for non-listed REITs increased to approximately $36.5 billion, about 99.97% of which was raised for NAV REITs. In the first six months of 2022, capital raising for non-listed REITs has been approximately $21.3 billion, about 99.93% of which was raised for NAV REITs. See The Stanger Market Pulse, December 2021 and June 2022. Only one lifecycle REIT is offered today; most are now closed to new investment and are in an operational phase only.

[5] NASAA adopted the Guidelines in 1996 and last updated them in 2007 only to change the dollar amounts for the income and net worth standards, years before NAV REITs became the predominate form of non-listed REIT in distribution. The Guidelines, for example, justify the suitability policy and standards for offerings "for which there is not likely to be a substantial and active secondary market." Although there is no secondary market, NAV REITs provide liquidity through regular share repurchase programs, thus obviating this perceived need for those restrictions.

[6] Non-listed REITs are heavily regulated.

- Non-listed REITs register their public offerings with the SEC under the Securities Act of 1933. Like other public companies, non-listed REITs must disclose the terms of their offerings in their registration statements and prospectuses, file them with the SEC, along with sales material that will be used in the offering and deliver the prospectuses to investors. These prospectuses must be amended, filed and delivered to investors as material developments occur.
- Non-listed REITs must register their offerings with each state and jurisdiction where offers and sales are made, which is generally all 50 states, the District of Columbia and Puerto Rico. The offerings are therefore subject to state regulatory review, whereas the offerings of listed companies are not.
- The dealer manager for each non-listed REIT offering must submit to FINRA the underwriting terms and arrangements for the offering and the SEC will not declare the offering effective until FINRA has issued a "no objections" letter related to underwriting terms and arrangements.

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- *The Proposal Would Inhibit Capital Formation.* Capital from the NAV REIT industry has been a significant source of economic activity and employment, supporting thousands of jobs in health care facilities, apartment buildings, shopping centers, office buildings and industrial warehouses. The Proposal would inhibit the flow of capital to these properties.

- *The Proposal – Particularly the Concentration Limits – Would Limit Investor Choice*. Many institutional investors allocate part of their investment portfolio to real estate in order to achieve diversification, lower portfolio risk, obtain inflation protection and receive steady income with the opportunity for capital appreciation. Yet NASAA would limit the ability of even sophisticated, wealthy investors to follow similar investment strategies. The Institute supports the ability of retail investors to obtain similar opportunities for portfolio diversification, inflation protection, and income as those available to institutional investors.

- *State Adoption of the Proposal May be Subject to Legal Challenge.* States likely would be preempted from adopting the Proposal by ERISA, the Securities Exchange Act of 1934, and the Investment Advisers Act of 1940. Moreover, routine incorporation of the Proposal into state rules would violate the laws of many jurisdictions that require state regulators to follow administrative rulemaking procedures.

- *The Proposal Would Regulate Investment Advisers and Broker-Dealers Through Issuer Disclosure*. The Proposal would attempt to impose a myriad of conduct standards on federally regulated investment advisers and broker-dealers and would do so through an issuer's charter and prospectus. It would create confusion and add undue complexity to the compliance programs of investment advisers and broker-dealers and could impose unworkable expectations on sponsors.

- *The Proposal Would Introduce an Unwarranted Prohibition on the Use of Proceeds*. The Proposal would prohibit distributions from gross offering proceeds. This prohibition would conflict with federal regulation and state corporate law with little justification.

1. **Regulation Should Fit the Product**.

The Proposal evidences a misimpression about the type of non-listed REIT sold today. The Proposal would only apply to REITs in distribution, but the Proposal appears to assume that lifecycle REITs are sold today. In fact, NAV REITs, and not lifecycle REITs, are virtually the only type of REIT currently in distribution.

- Non-listed REITs comply with the Securities Exchange Act of 1934 and therefore must file with the SEC annual reports, quarterly reports, other periodic reports and proxy statements. Like other public companies, REITs must include annual audited financial statements in their Annual Reports on Form 10-K and quarterly unaudited financial statements in their Quarterly Reports on Form 10-Q.

- Non-listed REITs are sold through broker-dealers that are regulated by FINRA, the SEC and the states, and registered investment advisers that are regulated by the SEC and the states.

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A. NAV REITs are not Lifecycle REITs.

As their name implies, lifecycle REITs have a "lifecycle" that is intended to terminate with a liquidity event such as a share listing or an acquisition or liquidation. In the structure of that product, investors paid up to 10% of their investment up front as underwriting compensation and usually bore the REIT's other "offering and organization expenses" of up to 5%. Legacy lifecycle REITs typically limited their repurchase programs to 5% of shares outstanding in any year. Sometimes they imposed other restrictions, such as by not allowing repurchases to exceed distribution reinvestments.[7]

In contrast, NAV REITs continuously offer their shares at net asset value ("NAV") over an indeterminate life and generally do not seek a liquidity event. NAV REIT fees are lower than those of the lifecycle REITs. Due to a shift to multiple share class options for an investor, the majority of NAV REIT shares are sold without any commission on a fee-based platform, presumably through fiduciary investment advisory accounts rather than commission brokerage accounts.[8] It was not uncommon for legacy lifecycle REITs to include acquisition fees, financing fees, and development and disposition fees as part of their fee structure. NAV REITs have largely eliminated these fees and pay their external advisor (or an affiliate thereof) a fixed management fee based on NAV and annual performance compensation based on the total return to stockholders that is only earned after a hurdle is achieved.

NAV REITs provide meaningfully increased liquidity for investors compared to lifecycle REITs. They typically offer to repurchase up to 2% of NAV per month and 5% of NAV per quarter – a four-fold increase from the amount of liquidity offered by lifecycle REITs. Unlike earlier lifecycle REITs, most NAV REITs allow stockholders to repurchase their shares at NAV per share without a mandatory holding period.[9]

Contrary to NASAA's assertions, these repurchase programs proved reliable during the pandemic. According to NASAA, the stockholders of only four NAV REITs – constituting less than 3% of all capital raised by the NAV REIT industry since January 1, 2017 – experienced any impediment to full redemption of their shares during the pandemic.[10] Put differently, during one of the most turbulent times

[7] Newer lifecycle REITs typically provide for regular quarterly redemptions, although most are not being offered and are in an operational phase only.

[8] As of June 30, 2022, only .03% of non-listed REIT shares sold in their continuous offering had a full load, while 35.66% of sales were in low load share classes and 64.31% of sales were in no load share classes purchased on a fee-based platform. Generally, "low load" share classes had an up-front 1.5%-3.5% combined sales commission and dealer manager fee, with a 0.25% to 0.85% annual stockholder servicing fee capped over the life of the REIT. "No load" shares typically were sold on fee-based platforms, often of a dually-registered broker-dealer/investment adviser. See The Stanger Market Pulse (June 2022).

[9] Most NAV REITs have an early repurchase discount between 2% and 5% if the shares are redeemed within 12 months of purchase to discourage short-term trading in the shares.

[10] Proposal at p. 7, n. 18. The four NAV REITs invested in assets that were particularly susceptible to valuation difficulties during the pandemic: mortgages, office properties, and retail properties. Stockholders in one of these NAV REITs, a mortgage REIT, received redemption requests that exceeded the previously disclosed caps. The REIT pro-rated redemptions and the repurchase program operated without interruption. This is an entirely appropriate outcome that was consistent with the terms of its repurchase program. Two others had converted to NAV REIT status only a few months before the pandemic began. The vast majority of shares of one were owned by legacy lifecycle stockholders, and the vast majority of shares of the other were held by legacy private REIT shareholders. The last NAV REIT mentioned by NASAA engaged in pro rata redemptions

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in the history of modern financial markets, NAV REITs representing over 97% of all raised funds satisfied all of their stockholders' redemption requests – no pro rata redemption, no suspension. By any objective measurement, the NAV REIT repurchase programs proved to be reliable during one of the most trying periods in modern finance.

Perhaps for these reasons, NAV REITs are distributed primarily by wirehouses and other "well-established financial institutions" that, in the words of the NASAA President, do not "generally permit" a "wider array of products" that could present investor protection concerns.[11]

B. NAV REITs Are Not Publicly Traded REITs.

The Proposal demonstrates an unjustified bias towards publicly traded REITs.[12] NAV REITs are intentionally not listed on a stock exchange. Instead, they provide liquidity through a regular repurchase program.

The difference between the price and value of REIT interests is crucial to an understanding of the differences between NAV REITs and publicly traded REITs. While the value of the real estate assets underlying a publicly traded REIT may not have changed dramatically, the price of its shares can fluctuate significantly with the volatility of the stock market. Indeed, an investment in publicly traded REITs can be even more volatile than an investment in the overall stock market.[13] Due to these fluctuations in share price, many retail investors sell in declining markets and purchase in rising ones.

By contrast, NAV REITs are generally positioned as longer-term investments yet provide liquidity through their repurchase programs. Stockholders have greater assurance that the price that they pay or receive for their stock represents the net asset value of the underlying portfolio, which is determined with the assistance of independent third parties, typically on a monthly basis. NAV REITs present less "timing risk" to investors.

NAV REITs also provide another advantage – greater portfolio diversification. The correlation between publicly traded REIT share price and the broader stock market means that investors who allocate from the broader stock market to publicly traded REITs may not have sufficiently increased their diversification or reduced their portfolio risk. Moreover, many NAV REITs are authorized to engage in tactical investment strategies, allocating assets to segments of the real estate sector that may provide the opportunity for more growth. Publicly traded REITs tend to be more statically focused on narrow real

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because its cap was exceeded, and later amended its repurchase program, as fully disclosed in its prospectus, to protect its liquidity during the pandemic by changing its caps.

[11] Testimony of Melanie Senter Lubin before the United States Senate Committee on Banking, Housing and Urban Affairs 7 (July 28, 2020) ("Lubin Testimony").

[12] For example, the concentration limits would apply to REITs "for which there is not likely to be a substantial and active secondary market." Proposal, III.D.1.

[13] The VGSIX recently recorded a 5-year standard deviation of 16.81%, compared to 15.65% for the SPDR S&P 500 Index Trust. Cf. https://institutional.vanguard.com/investments/product-details/fund/0123 (VGSIX) and https://screener.fidelity.com/ftgw/etf/goto/snapshot/performance.jhtml?symbols=SPY (SPDR S&P 500 Index Trust).

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estate sectors, thus increasing concentration in those sectors. NAV REITs performed much better during the pandemic than publicly traded REITs.[14]

2. Regulation Should Not Stifle Local Business.

Capital formation in the NAV REIT sector has been a significant source of economic activity and employment, supporting thousands of jobs in health care facilities, apartment buildings, shopping centers, office buildings and industrial warehouses. Real estate development is fundamental to economic growth and employment. The Proposal would constrain growth in the real estate sector at an unpropitious time of high inflation and possible recession.

More, not less, capital is necessary to make housing affordable to middle income families. According to a 2020 Institute survey of our members, approximately 63% of non-listed REIT investment in multifamily housing supports workforce housing, defined as multifamily housing with rent less than 25% of mean family income in the surrounding area.

The Proposal also would lead to limits on investment in business development companies that help capitalize small business. NASAA's proposal would stifle access to capital by small and mid-sized U.S. companies, including minority-owned, women-owned and veteran-owned businesses that may not have access to traditional sources of capital. Alternative investment strategies allow these businesses to grow with terms more flexible than those offered by bank loans. NASAA has stated that the Proposal will influence guidance concerning some of these other alternative investments such as BDCs.[15]

In short, by limiting investment in NAV REITs, any state that adopts the Proposal would impede the flow of capital to local business.

3. Regulation Should Preserve Investor Choice.

The concentration limits and the increase in the income and net worth requirements would restrict investment choice. As the world emerges from the worst of the pandemic, gas prices have been at their all-time high and food prices rose at the fastest pace in 41 years.[16] Inflation and interest rates are on everyone's mind. Economists predict stagflation and recession. With these critical economic headwinds along with recent geopolitical events from lockdowns in China and Russia's invasion of Ukraine many investors need portfolio diversification, protection from inflation, and a reliable source of income. Investors have found that NAV REITs are part of the solution. Yet the Proposal would discourage investment in a diversifying asset when macroeconomic events make diversification, consistent with the basic tenets of modern portfolio theory, so important.[17]

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[14] For example, in the first quarter of 2020, the value of the VGSIX plummeted more than 24%, losing almost 5% for the year. https://finance.yahoo.com/quote/VGSIX/performance. The changes in NAV REITs' valuations were smoother, and they returned a positive 5.33% in 2020. The IPA/Stanger Monitor (Summer 2022).

[15] Proposal at 2.

[16] See https://www.agriculture.com/news/business/food-prices-rise-at-fastest-pace-in-41-years.

[17] See, e.g., Markowitz, "Portfolio Selection," The Journal of Finance (1952).

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A. The Proposal Would Disadvantage Retail Investors.

State public employee pension plans and other institutions invest in real estate to achieve diversification and reduce their portfolio risk. The Ohio Public Employees Retirement System Defined Benefit Plan, for example, targets over 23% of its assets to alternative investments, with 10% to real estate.[18] The nation's largest pension fund, the California Public Employees' Retirement System, reportedly experienced a 24.1% return on real estate for the 12 months ending March 31, 2022. In contrast, other smaller pension plans that were concentrated in the stock and bond market suffered their worst year since 2009.[19]

The concentration limits in the Proposal would deprive retail investors of similar investment opportunities. They would provide no carve-out for accredited investors. In 2016 NASAA proposed amendments to the Guidelines that would have included a concentration limit with an accredited investor exemption.[20] The Proposal does not explain why the proposed accredited investor exemption has been removed. An accredited investor exemption would not be inappropriate in light of the substantial investor protections afforded to investors in NAV REITs.

The Proposal thus would impede even wealthy investors, advised by their federally regulated broker or investment adviser, from following portfolio diversification strategies like those employed by big institutions. For example, an investment adviser might recommend that a client with enough cash to meet reasonably foreseeable needs, diversify her portfolio by investing more than 10% of her net worth in an NAV REIT. The REIT might be one in which she has a long history of successful investing. The Proposal would preclude the fiduciary's recommendation. Clearly, no one is in a better position to evaluate what is best for investors than investors and their financial advisors. Regulators should not interfere with these decisions, especially with respect to wealthier investors.

Of course, even less wealthy retail investors may need the portfolio diversification and other benefits that can come from investing in NAV REITs. The Proposal would erect a barrier for investors from investing in this well-regulated investment, potentially diverting them toward other, less regulated and transparent ones. These would include securities for which (in the words of NASAA's President) "state securities regulators dedicate significant resources to respond to fraud and other violations."[21] The Proposal could inadvertently and unnecessarily harm retail investors by limiting choice and unintentionally resulting in a reduction of product options available.

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[18] OPERS 2022 Annual Investment Plan at 6 https://www.opers.org/pubs-archive/investments/inv-plan/2022-Annual-Investment-Plan.pdf.

[19] "State and City Pension Funds Suffer Worst Year Since 2009," The Wall Street Journal (August 10, 2022).

[20] https://www.nasaa.org/wp-content/uploads/2016/07/Notice-for-Public-Comment-REIT-Concentration-Limit-07272016.pdf.

[21] Lubin Testimony at 8.

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B. The Proposal Would Perpetuate a Multitude of Non-Uniform Standards.

The Proposal says,

> In light of . . . a proliferation of non-uniform concentration limit standards within the membership, NASAA is renewing advancement of a uniform concentration limit to the NASAA REIT Guidelines.[22]

The Proposal would not, however, establish a uniform concentration limit. It would require the sponsor to propose a concentration limit particular to its own REIT, and each state administrator could accept or adjust the limit based upon a list of 14 wide-ranging factors. These factors would include "the REIT's use of leverage,“ "balloon payment financing," "potential variances in cash distributions," "prior performance," and "any other relevant factors."[23]

A state administrator could adopt the sponsor's proposed limit or demand that the sponsor accept a higher or lower limit. The sponsor might not be afforded notice of the factors considered or the process followed in reaching a determination. A state administrator also could establish a limit that applies to all NAV REITs that apply for registration in the state. The 10% concentration limit would apply only if the state does not establish its own concentration limit.

Any state would be free to choose a different concentration limit. Any limit, whether 10% or another, would be a subjective condition that fails to consider the needs of an individual investor, and would interfere with the judgment of their financial professional on factors including age, risk tolerance, financial objectives and other life circumstances. As a practical matter, many sponsors would comply with the most restrictive standard, rather than trying to conform with a multitude of state requirements. Any state that does not adopt the strictest standard would find its own limits to be ignored.

Experience demonstrates that uniformity is impossible. Even today, up to 20 states have imposed concentration limits that include variations in the investments that are subject to the concentration limits such as: the REIT and its affiliates; all non-listed REITs; and all non-listed REITs and other direct participation programs. Some states provide an exception for accredited investors, while others do not. NASAA cannot force these states to adopt a single, uniform percentage and the Proposal does not even attempt to do this. Moreover, while uniformity has some benefits, if it is accomplished via adoption of the strictest concentration limit, investors may be harmed by the change.

C. The Concentration Limits Are Unjustified.

The majority of states do not impose a concentration limit today. NASAA has provided no justification or economic analysis for any concentration limit. It has not explained why a 10% limit is preferable to any other limit, say, 15%, 20%, 25% or 30%. NASAA has not demonstrated that NAV REIT investment concentration has presented any liquidity problems for investors. To the extent that

[22] Proposal at p. 7.

[23] Proposal, III.D.

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NASAA is concerned about emergency liquidity situations[24], some NAV REITs accommodate those situations, such as by giving preference, when repurchases will not cover all shares submitted, to requests due to death, disability or divorce.

NASAA asserts that the concentration provision will "limit investor risk."[25] According to NASAA's most recent statistics, non-listed REITs are not a significant source of complaints related to senior investor fraud. According to NASAA's 2021 Enforcement Report, the "Top Investment Products/Sales Tactics in Senior-Related Enforcement Actions" are unregistered securities, traditional securities, commodities/precious metals, variable annuities and equity indexed annuities.[26]

NASAA would impose the concentration limits through the offering registration, but they would be applied not by the REIT or its sponsor, but by the broker-dealers and investment advisers who are acting in their customers' best interest. NASAA thus would substitute its judgment for the best interests of each investor and their financial professional.

SEC and FINRA rules already require that broker-dealers and investment advisers consider the portfolio concentration and liquidity needs of each investor, and the SEC and FINRA have emphasized the responsibilities of regulated firms to supervise recommendations to senior investors. As NASAA itself notes, FINRA recently barred a registered representative for making unsuitable recommendations to senior customers concerning non-listed REITs.[27] This case and the other seven listed in footnote 11 of the Proposal all concerned sales practice violations related to the distribution of lifecycle REITs, not NAV REITs. Moreover, none of them alleged any violation by the REIT itself.

Indeed, many broker-dealers comply with Regulation Best Interest ("Reg BI") by limiting each customer's investment concentration according to factors relevant to the security and that customer. These concentration limits typically apply to securities whose liquidity is not unlimited, such as non-listed REITs and business development companies, interval funds, limited partnerships, hedge funds, and variable annuities. The limits are often imposed on customers according to a sliding scale derived from a customer's age, risk tolerance, investment time horizon, income, and net worth. The limits can consist of a percentage of investable net worth in a single offering and a percentage of investable net worth in all similar products. The limits normally are higher for customers with high net worth and sufficient liquidity.

The Proposal also does not explain why the proposed standard should be based on liquid net worth rather than the size of the investor's investment portfolio. An investor might have a $500 million business or inherited real estate portfolio, but not $1 of that business or portfolio could be considered for

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[24] Proposal at p. 8 (using "liquid net worth . . helps ensure that some liquid funds are available for emergency purposes without penalty to the investor."

[25] Proposal at p. 3.

[26] https://www.nasaa.org/wp-content/uploads/2021/09/2021-Enforcement-Report-Based-on-2020-Data-FINAL.pdf

[27] Department of Enforcement v. Mercer Hicks III (May 19, 2021), https://www.finra.org/sites/default/files/2021-07/oho-hicks-2017052867301-051921.pdf.

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purposes of the concentration limits. NASAA would impose its judgment about what is in the best interest of this investor and all other investors, without any basis for doing so.

D. The Concentration Limits Would Inappropriately Apply to Other Securities.

The new concentration limits would apply not only to retail investment in non-listed REITs but to securities of an "affiliate" and "other non-traded direct participation programs," the latter term undefined by the Proposal. [28] (NASAA does not define "direct participation program" and FINRA's definition excludes REITs.[29]) It appears that if an investor held one share of a non-listed REIT, she would be unable to purchase in the aggregate any security issued or managed by an affiliate of the REIT and any DPP, in excess of 10% of her liquid net worth.

The Proposal would define "affiliate" to include "any person directly or indirectly controlling, controlled by, of [sic] under common control with such other person,"[30] potentially including index funds or other registered investment companies managed by its sponsor. These registered investment companies do not implicate the concerns identified in the proposal[31], and imposing the concentration limits on these funds would be unnecessary and counterproductive. Registered investment companies are comprehensively regulated under the Investment Company Act of 1940. They typically have separate boards of directors, charged with overseeing conflicts and daily liquidity, among other issues. The proposed concentration limits could force investors to choose whether to limit their investment in the NAV REIT (limiting their diversification opportunities) or in these types of affiliated investment companies (limiting their investment choice).

NASAA has not explained why the mere fact that securities are issued or managed by an affiliate warrants their subjugation to the concentration limits. Moreover, because the term "direct participation program" is undefined, market participants will be uncertain how it should be applied. By including DPPs and affiliate securities in the concentration limits, NASAA would discourage the continued entry of the types of sponsors who provide high-quality, transparent investments: large asset management companies with an established record and a platform of wide investment choices.

E. Application of the Concentration Limits is Incongruous.

The Proposal would provide no specificity in time for evaluating the concentration limits, for example, "at the time of recommendation." Perhaps NASAA does not expect investment advisers and

[28] Proposal, III.D.3.

[29] See FINRA Rule 2310(a)(4).

[30] Proposal, I.5.C.

[31] See Proposal at 7:

> This structure was chosen based on the observation that liquidity is restricted in all programs; high fees and expenses, conflicts, and lack of historical operations also predominate these offerings.

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broker-dealers to monitor continued compliance with the concentration limits, but if it does, this feature would be unworkable.

For example, an investor might not exceed the concentration limit at the time of the initial subscription for primary shares, but over time, due to the investor's participation in the REIT's distribution reinvestment program, the investor could trip the concentration limit. Another investor might find that the listed stocks in her portfolio declined in value and she has exceeded the concentration limits without having purchased another REIT share.

The Proposal has no grandfather provision. An investor who owns shares at the time that his state adopts a concentration limit might inadvertently violate them.

Finally, what would NASAA require in all of these cases? Neither the REIT sponsor nor an investor's financial professional can force the investor to sell his shares.

F. The Concentration Limits Would Interfere With Corporate Governance.

The concentration limits would impose an impractical requirement on the corporate governance of NAV REITs. In particular, the Proposal would require that the concentration limits be added to the charter of an NAV REIT. Without a grandfather provision, a NAV REIT would be forced to conduct a proxy solicitation for this change to its charter. This process would be costly and time consuming, and the costs would be passed along to the stockholders. And to solve this problem with a grandfather provision would put new sponsors at a competitive disadvantage.

G. The Gross Income/Net Worth Limits Would Unnecessarily Constrain Investor Choice.

The Proposal would index existing gross income and net worth limits to inflation, backwards to 2007. The existing gross income limits themselves are incompatible with the federal scheme of securities regulation. Publicly-offered securities registered under the Securities Act of 1933 must provide full disclosure to investors and issuers are subject to strict liability under Section 11 of the Act. Because of this disclosure regime, retail investors may invest in these securities regardless of their income or net worth. Issuers of privately placed securities need not provide similar disclosure and for that reason the ability of investors to purchase these securities is limited. For example, the SEC's accredited investor standard applies to private placements under Regulation D.

Against this federal system of regulation, the Proposal would prevent investors from obtaining the portfolio diversification and other benefits from investing in publicly-offered, federally-registered NAV REITs. NAV REITs are distributed through registered broker-dealers and investment advisers who must comply with Reg BI or the investment adviser fiduciary duty and in doing so, must consider the income and net worth of the retail investor.

The gross income and net worth limits are therefore unnecessary constraints upon investor choice. It would keep investors who do not have access to the private markets from diversifying their portfolio by investing in well-regulated NAV REITs.

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H. The Limit on Investor Choice Is Not Economically Justified.

The Proposal has not been supported by any economic analysis. NASAA has provided little data other than a few discredited sources.

For example, NASAA cites the work of litigation consultants who "found that [from June 1990 to December 2019] investors in non-traded REITs underperformed investors in traded REITs by approximately $75 billion."[32] The study suffered from at least four fundamental errors. First, it erroneously compared the performance of NAV REITs to a mutual fund that is closed to new investors and tracks an index of publicly-listed REITs. The authors did not even acknowledge the vast differences in the structure and operations of NAV REITs and publicly-listed REITs. Second, it combined data about legacy lifecycle REITs that are rarely offered today and NAV REITs that are virtually the only non-listed REIT offered today. Third, its time period was conveniently fitted to end immediately before the pandemic, when NAV REITs outperformed publicly-listed REITs. Fourth, it arbitrarily, and without any justification, discounted the valuations of NAV REITs in order to make the performance of publicly-listed REITs appear superior.[33]

NASAA also relies on its recent Reg BI report allegedly indicating that "many broker-dealer firms have not materially changed their policies, procedures, or practices regarding the sale of non-traded REITs or other complex, costly, and risky products to retail investors since the passage of Reg BI. . ..."[34] The Institute and 11 other organizations retained Greenwald Research, an independent, established expert in research and survey methodology, to analyze NASAA's report.[35] Greenwald Research found that the report failed to meet eight well-accepted standards and codes of conduct for survey research. These insufficient practices included a focus on certain investment product types that NASAA apparently disfavored and arbitrarily deemed "complex, costly and risky," a failure to obtain accurate measurements of the impact of Reg BI on respondent firms, a failure to accurately measure compliance with Reg BI and asking instead about policies that Reg BI does not require, a failure to collect information on key actions

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32 Proposal, note 8 (citing Mallett and McCann, Further on the Returns to Non-Traded REITs, The Journal of Wealth Management Winter 2021).

33 See Selman, Non-Traded REIT Performance: A Response to Mallett and McCann, The Journal of Wealth Management Fall 2022. Moreover, federal courts have observed on a number of occasions that McCann's work cannot be relied upon. One court has concluded that a report McCann prepared was "deeply flawed," as it "contained several significant errors" that caused McCann to "improperly" and "erroneously" analyze market data. In re Fed. Home Loan Mortg. Corp. (Freddie Mac) Sec. Litig., 281 F.R.D. 174 (S.D.N.Y. Mar. 27, 2012). That court also observed that McCann conceded that his analysis in another study was not correct and that McCann's testimony was "unreliable and unpersuasive." Id. at 181. And the Fifth Circuit noted that McCann provided inconsistent testimony in two related arbitrations, which McCann attributed to the fact that "one of his staff members had failed to account for certain internally-priced securities in the calculations, and that correcting the mistakes had generated different numbers." Morgan Keegan & Co., Inc. v. Garrett et al., No. 11-20736 (5th Cir. Oct. 23, 2012) (per curiam).

34 Proposal at 3 (citing NASAA Reg BI Phase IIA Report (Nov. 2021)).

35 ANALYSIS OF NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION'S (NASAA) REG BI SURVEYS Prepared by Greenwald Research FEBRUARY 2022, available at https://greenwaldresearch.com/wp-content/uploads/2022/02/Analysis-of-NASAA-Surveys-on-Reg-BI-Greenwald-Research-2.22.pdf.

that firms have taken pertinent to Reg BI, and mischaracterization of the survey results. Instead, NASAA simply repeats the conclusions in the Proposal.

NASAA also relies on FINRA arbitration claims, citing merely Top Controversy Types rather than awards.[36] Reliance on this data is misguided because it wrongly assumes that each claim resulted in an award, or that each claim constituted a sales practice violation rather than another type of claim such as one for breach of contract. Moreover, multiple products are often the subject of a single claim and typically concern the distribution of a product, not its design or operation. In other words, while an arbitration may involve the registered representative's practices or the firm's supervision, it typically does not impugn the structure or operation of the underlying investment.

According to FINRA, in 2021 customers asserted breach of contract claims in 1,110 cases, violation of blue sky laws in 355, errors charges in 127, and execution error in 84.[37] Other allegations might have been made in some cases, but NASAA did not distinguish the claims according to the level of sales practice concern or the product involved.

4. Any State Adopting the Proposal Could Face Legal Challenge.

The Proposal could face legal challenge.

A. State Adoption Likely Would Violate Federal Law.

The federal securities laws and ERISA likely would preempt the proposal. For example, because the Proposal would apply to federally registered investment advisers, the Investment Advisers Act of 1940 likely would preempt it.[38] The Proposal would retain the requirement that sponsors or each person "selling shares on behalf of the sponsor or REIT" maintain records of the information used to determine that an investment is suitable and appropriate.[39] This requirement likely violates the Securities Exchange Act.[40] ERISA also likely would preempt the Proposal, since it would apply to investment advisers and

[36] Id. at 12-13.

[37] See https://www.finra.org/arbitration-mediation/dispute-resolution-statistics.

[38] Proposal, I.B.8. ("conduct standards" includes federal fiduciary duties). Section 203A of the Investment Advisers Act preempts the states from exercising jurisdiction over federally registered investment advisers, other than by investigating individual cases of fraud and deceit.

[39] Proposal, III.C.4.

[40] Section 15(i) of the Securities Exchange Act states, "No law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof shall establish . . . making and keeping records . . . requirements for brokers [or] dealers that differ from, or are in addition to, the requirements in those areas established under this title."

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broker-dealers who recommend REIT shares to employee benefit plans[41] and would require that the sponsor make every reasonable effort to determine that the purchase complies with ERISA.[42]

B. State Incorporation Likely Would Violate State Law.

Routine incorporation of the Proposal into state rules likely would violate the statutes of many states that impose administrative rulemaking procedures. These state statutes typically require public notice and comment before the administrator may adopt any rule. Routine incorporation of the Proposal into state rules could circumvent this statutory process.

Moreover, the operation of the Proposal could violate state registration-by-coordination provisions. NAV REITs are registered by coordination in most states. Registration by coordination occurs "at the moment" of SEC registration.[43] The purpose of this procedure is to ensure that state registration is coordinated with the primary regulator of these offerings, the SEC.[44] According to the official commentary to the Uniform Securities Act (1956), registration by coordination "is designed to achieve simultaneous effectiveness at the federal and state levels"[45] and "limits the Administrator to requiring only such information as is filed with the SEC."[46]

The Proposal would require state administrators to apply conditions on any offering that are different from those imposed by the SEC, such as disclosure requirements, concentration limits, and restrictions on the use of gross offering proceeds. Even today, the Guidelines conflict with state registration-by-coordination requirements by requiring merit review of securities that are simultaneously registered under state law "at the moment" of SEC registration. Several states comment on NAV REIT applications for registration, contrary to the registration-by-coordination provisions in their state statutes. This process can delay these state registrations for months after the SEC's declaration of the offering's effectiveness.

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[41] Proposal, III.C.1 (recommendation or advice to "a shareholder").

[42] Proposal, III.C.5; I.B.8. ("conduct standards" includes ERISA). ERISA section 514(a) provides that, except as otherwise provided in section 514(b), title I and title IV "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan."

[43] See, e.g., Maryland Section 11-503(c); Ohio Revised Code Section 1707.091(C); Uniform Securities Act Section 303 (2002), https://www.uniformlaws.org; Uniform Securities Act Section 303 (1956), https://www.nasaa.org/wp-content/uploads/2021/10/1956-Uniform-Securities-Act-with-NASAA-Updates-and-Commentary.pdf.

[44] By contrast, registration by qualification is an extensive process that requires a set of findings. As the SEC has said after adoption of the National Securities Markets Improvement Act, registration by qualification "requires a full review of the transaction by the state." Report on the Uniformity of State Regulatory Requirements for Offerings of Securities That Are Not "Covered Securities" (October 11, 1997), https://www.sec.gov/news/studies/uniformy.htm.

[45] Uniform Securities Law (1956), Section 303(c).

[46] See Sec. 303(b)—Filing same as with SEC. https://www.nasaa.org/wp-content/uploads/2021/10/1956-Uniform-Securities-Act-with-NASAA-Updates-and-Commentary.pdf.

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Under the Proposal, state administrator would need to review the prospectus and formulate and issue comments requesting changes to the prospectus disclosure. It would be difficult for the registration of an NAV REIT offering to become effective in the states simultaneous with the effective date of SEC registration as state registration-by-coordination requires. The Proposal thus would conflict with state registration-by-coordination provisions.

The Proposal similarly could conflict with state notice filing provisions. It would impose concentration limits not only for investments in NAV REITs but on other securities offered by the sponsor and its affiliates, including index funds, tender-offer funds and, interval funds.[47] The latter securities are covered securities that are exempt from state registration. The Proposal effectively would impose a condition on the offerings of these alternative investments in a state – that no investor exceed the state's concentration limits.

5. Compliance Departments Need Clarity, Not Confusion.

The Proposal would create a panoply of state conduct standards that would interfere with broker-dealer compliance and undermine investor protection. NASAA claims that it is merely updating the Guidelines to account for Reg BI. The Proposal would conflict with Reg BI.

A. A National Product Deserves a National Standard.

NAV REITs are nationally offered and distributed investments. In 2021, NAV REITs raised over $36 billion and in the first half of 2022 the pace has quickened as NAV REITs raised over $21 billion.[48] NAV REITs are sponsored and managed by some of the largest and most successful asset management companies in the country, and they are distributed through nationally situated wirehouses, independent broker-dealers, and registered investment advisers.

The Proposal would subject this national product to a dizzying array of state conduct standards. Under the Proposal each person selling, recommending or providing investment advice with regard to a REIT would have to:

> make every reasonable effort to determine that such sale, recommendation or investment advice is in compliance with applicable conduct standards and is a suitable and appropriate investment for each shareholder.[49]

The Proposal would define "conduct standards" to include Reg BI, ERISA, and applicable fiduciary duties and anticipated state standards not even enacted yet. Moreover, under the Proposal broker-dealers and their associated persons would have to:

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[47] Proposal, III.D.

[48] See The Stanger Market Pulse (December 2021 and June 2022).

[49] Proposal, III.C.1.

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act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer or associated person making the recommendation ahead of the interest of the retail customer.[50]

This best interest standard resembles only the Care Obligation under Reg BI, but it is set forth separately in the Proposal.

The Proposal thus would impose four categories of conduct standards:

- conduct standards that federal or state law imposes on the person selling, recommending, or providing investment advice (Reg BI, ERISA, fiduciary duty);
- a state law requirement that the investment be "suitable;"
- a state law requirement that the investment be "appropriate;" and
- a state law requirement that the investment be in the retail investor's "best interest."[51]

NASAA provides no explanation about how these various conduct standards would interact with one another or about the contours of the state requirements. The Proposal would offer state administrators the ability to impose the conduct standards however the administrator pleases, under whatever facts the administrator chooses, without any expectation of consistency with the SEC, FINRA, or other state administrators. The determination of any state administrator would likely be subject to state judicial review as well.

This myriad of requirements for the same conduct would sow chaos in the compliance departments of regulated firms. They would undermine, not advance investor protection.

B. Conduct Standards Should be Product Agnostic.

NASAA would impose conduct standards on a particular product, NAV REITs, but the Reg BI conduct standards are intentionally product agnostic and do not contain any specific limitation based on product type. No provision of Reg BI addresses specific types of securities. The Department of Labor's interpretations of ERISA and the SEC's investment adviser fiduciary duty are also not altered according to the security being recommended. The Proposal would distort these conduct standards by applying them only to NAV REITs at the state level.

Broker-dealers and investment advisers are used to applying these standards in the product-agnostic manner in which they are written. By imposing these broad principles only to NAV REITs and other products, the Proposal would confuse the compliance departments of broker-dealers and investment advisers. They would be uncertain how these various standards would apply differently to NAV REITs from other products. The Proposal would complicate their efforts to ensure that financial professionals engage in proper sales practices.

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[50] Proposal, III.C.1.

[51] The Proposal also would impose "suitability" and "appropriateness" standards on broker-dealers who recommend non-listed REITs to non-retail customers. Proposal, III.C.1.

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C. Sponsors Cannot Supervise Independent Financial Intermediaries.

The Proposal would require sponsors or each person "selling shares on behalf of the sponsor or REIT" to maintain records of the information used to determine that an investment is suitable and appropriate.[52] The Proposal also would require sponsors to disclose in the final prospectus:

> the responsibility of the sponsor and/or each person selling shares or providing a recommendation on behalf of the sponsor or REIT to make every reasonable effort to determine that the purchase of shares, recommendation or advice is a suitable and appropriate investment for each shareholder and/or in compliance with applicable conduct standards, based on information provided by the shareholder regarding the shareholder's financial situation and investment objectives.[53]

These provisions are ambiguous, and perhaps NASAA did not intend that issuers police the conduct of financial intermediaries over whom they lack supervisory authority. If that is the intention, however, then the Proposal will be unsuccessful. As a practical matter, no sponsor is able to determine whether a purchase complied with the conduct standards of a broker-dealer, investment adviser or its representatives.[54] The sponsor cannot be presumed to have expertise about Reg BI, ERISA or the investment adviser fiduciary duty.

Broker-dealers and investment advisers would find that their supervision of associated persons has been complicated by the intrusion of this sponsor oversight. The Proposal could foster multiple overlapping supervisory systems, some imposed by the sponsor and some by the financial intermediary. These systems might be regulated by the SEC, FINRA, and the states. Such an approach would generate confusion and costly compliance that does not serve investors and, indeed, could harm them.

D. Conduct Standards Cannot be Imposed Through Prospectus Disclosure or Charter Provisions.

Securities regulators should not use disclosure or charter provisions as a means to apply conduct standards to securities distributors. Any conduct standard should be framed according to the practices of those to whom it will apply and developed through public rulemaking. A prospectus does not bind a broker-dealer or a registered investment adviser. Similarly, a charter is a contract between the issuer, the stockholders and the state. Broker-dealers and registered investment advisers are not party to that contract. Neither the prospectus nor the charter is the correct medium for imposition of conduct standards.

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[52] Proposal, III.C.4.

[53] Proposal, III.C.5.

[54] The concentration limits imposed through securities registration similarly would be requirements that neither the REIT nor the sponsor could implement. Concentration limits would have to be managed by the broker-dealers and investment advisers who recommend the product as part of their best interest or fiduciary obligation.

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6. Regulation Should Be Consistent.

The Proposal would impose an unwarranted prohibition on the use of proceeds – one that would conflict with federal regulation and state corporate law. The prohibition also could discriminate against new REITs entering the market.

In three sentences the Proposal would prohibit the use of gross proceeds for stockholder distributions:

> The REIT may not have an investment objective or strategy to source regular distributions with gross offering proceeds from the sale of shares.[55]
>
> The REIT may not reserve the right that gross offering proceeds from the sale of shares will be reserved or used to source regular or declared distributions.[56]
>
> The REIT may not source regular or declared distributions from gross offering proceeds.[57]

These three statements are different and they will engender abundant interpretive questions as various states implement them. Under federal law, a REIT must make distributions to stockholders equal to at least 90% of its net taxable income each year (determined without regard to the dividends-paid deduction and excluding net capital gain). The Proposal could jeopardize a REIT's federal tax status.

The SEC does not prohibit the payment of distributions from offering proceeds, having explicitly addressed this question, provided that the REITs include appropriate disclosure in the prospectus.[58] Moreover, the SEC has published disclosure guidance that requires non-listed REITs to present, on a quarterly basis, the source or sources used to fund distributions.[59] Because this disclosure is available each quarter, investors have adequate historical information regarding the sources used to fund distributions prior to making an investment decision. Broker-dealers and due diligence firms review the historical distribution coverage to determine if they should make an investment in the REIT available to their clients. They pay close attention to distribution coverage, and a failure to demonstrate full coverage or positive trends toward full future coverage could result in firms suspending or terminating a selling agreement.

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[55] Proposal, V.E.1.

[56] Proposal, V.K.1.

[57] Proposal, VI.H.

[58] SEC Division of Corporation Finance, CF Disclosure Guidance: Topic No. 6, Staff Observations Regarding Disclosures of Non-Traded Real Estate Investment Trusts, July 16, 2013, available at https://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic6.htm ("SEC Disclosure Guidance: Topic No. 6").

[59] SEC Disclosure Guidance: Topic No. 6.

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The Proposal would prohibit a practice that other state laws permit and that is an essential determination of a REIT's board of directors. Most NAV REITs are Maryland corporations and Maryland law permits the use of proceeds for distribution if it is approved by the board of directors, which has a fiduciary obligation to both the REIT and its stockholders. The ability to make determinations on how to fund distributions, through offering proceeds or otherwise, is an essential function of the board. The board establishes a distribution rate that it deems appropriate and sustainable based on the board's expectation of the total level of return to be generated from cash flows and real estate appreciation over the expected holding period. If the cash flow and appreciation exceed the distribution rate set by the board, it will have a positive impact on NAV. If they do not exceed the distribution rate set by the board, then it will have a negative impact on NAV.

The NAV REITs raising capital today publish their net asset value on a daily or monthly basis. This practice is an improvement for investors, who receive regular disclosure regarding the value of their investment in the REIT and are no longer sent account statements for extended periods that show a "value" equal to the price they paid for the investment. Thus, any negative effect of the payment of distributions from offering proceeds will be apparent to investors and their financial advisors.

* * *

The Institute appreciates the opportunity to comment on the Proposal. We are ready and willing to work with NASAA members on ensuring that any guidance that they provide accurately reflects the characteristics of NAV REITs, the needs of investors, and the obligations of financial professionals to act in their best interest. In the meantime, should any member of NASAA or its staff have any question about our comments, please feel free to contact me at (202) 548-7190.

Sincerely,

Anya Coverman
SVP, Government Affairs and General Counsel
Insitute for Portfolio Alternatives