August 30, 2023

Via Email to roger.patrick@com.ohio.gov
Ohio Department of Commerce
Division of Securities

Re: Ohio Division of Securities Rule 1301:6-3-09 Registration by qualification

Dear Mr. Patrick:

On behalf of the undersigned organizations, we write in **strong opposition** to the Ohio Division of Securities' above-captioned proposed rule to provide a new waiver process and self-executing form that would eliminate Ohio's concentration limit for the purchase of non-traded real estate investment trusts (REITs) and business development companies (BDCs) for all Ohio investors.[1]

As background, non-traded REITs and BDCs are often marketed and sold to retail investors, including older savers, as high-yield and predictable assets. However, these assets come with significant risks, including that they are often highly speculative investments that can impose devastating losses on investors, they often have severe restrictions on investors' ability to sell their interests in these products, and income distributions can be modified or suspended at any time, leaving investors without a reliable source of cash flow to cover foreseeable and unforeseeable expenses.[2] In addition, non-traded REITs and BDCs are extraordinarily high-cost investments that can drain retail investors' hard-earned money and underperform more liquid and diversified alternatives. Finally, non-traded REITs and BDCs are rife with conflicts of interest, which expose retail investors to sales-driven abuses. Researchers estimate that investors nationwide have lost more than $75 billion from non-traded REITs in recent years.[3]

Given these risks and costs to retail investors regarding non-traded REITs and BDCs, we believe investors need greater protections in this area and, accordingly, strongly support the North American Securities Administrators Association's (NASAA's) efforts to update its policy regarding REITs to ensure that retail investors receive the protections they need when investing in these products.[4] Unfortunately, this proposal would go in the opposite direction, removing protections for Ohio investors and leaving them vulnerable to the significant risks that non-traded REITs and BDCs often impose on retail investors.

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[1] The existing concentration limit caps Ohio investor's purchase of these products up to 20 percent of their liquid net worth (10 percent in a non-traded REIT and another 10 percent in a non-affiliated BDC). As discussed below, we urge the Securities Division to strengthen the concentration limit by capping the *combined* amount of non-traded REITs and BDCs Ohio investors can purchase at 10 percent.

[2] *See* SEC, Investor Bulletin: Non-traded REITs, Aug. 31, 2015, https://www.sec.gov/resources-investors/investor-alerts-bulletins/non-traded-reits. *See also* Peter Grant, *Individual Investors Find Withdrawal Window Shut for Property Funds; Inability to cash out shares in nontraded REITs couldn't come at a worse time for many small investors*, WALL STREET JOURNAL, April 14, 2020, https://www.wsj.com/articles/individual-investors-find-withdrawal-window-shut-for-property-funds11586865601.

[3] Joshua Mallett and Craig McCann, *Further on the Returns to Non-Traded REITs*, THE JOURNAL OF WEALTH MANAGEMENT WINTER 2021, 24 (3) 113-127; DOI: https://doi.org/10.3905/jwm.2021.1.153.

[4] We have included that letter as an attachment to this letter.

1. We oppose codifying *any* waiver process to eliminate Ohio's concentration limit for the purchase of non-traded REITs and BDCs.

The current concentration limit for the purchase of non-traded REITs and BDCs has provided strong protections for Ohio investors for approximately 20 years, limiting the extent to which they risk being defrauded, suffering significant and unrecoverable losses, and having their hard-earned money locked up for more time than they can bear. These protections have been especially beneficial for older investors, who may be particularly vulnerable to devastating outcomes if they suffer significant losses or have their assets frozen. Moreover, these protections have helped to ensure that Ohio investors maintain adequate diversification among their investments such that they are not overly exposed to the risk of loss or illiquidity from a single investment or single type of investment.

Codifying a waiver process for the current concentration limit, on the other hand, would remove these protections and expose Ohio investors to greater risks and losses. Allowing REITs and BDCs to be sold without any concentration limit would expose older investors in particular to having excessive concentrations of their savings, including up to *their entire life savings*, steered toward and tied up in these risky and illiquid products. For example, the Securities Division's own exam data indicates that sales of these assets are often targeted at older investors. Specifically, its exam data indicates that 80 percent of Ohio investors who purchase non-traded REITs and BDCs are over 55 years old and 45 percent are over 65 years old.

2A. We oppose a waiver process for Ohio's concentration limit for the purchase of non-traded REITs and BDCs that is available to all Ohio investors, as proposed.

Removing the current concentration limit for the purchase of non-traded REITs and BDCs for all Ohio investors would place all Ohio investors at greater risks from these products. It is likely that many vulnerable Ohio investors who can ill-afford to have significant amounts of their portfolios locked up in these risky assets would have the bulk of their portfolios steered to these products by self-interested financial professionals, who sell these products because they are compensated handsomely for doing so. Many Ohio investors would be overexposed to these products and would likely suffer significant and unrecoverable harms as a result, including experiencing devastating losses and cash shortfalls that compromise their ability to cover living expenses. This would be a terribly unfortunate outcome, considering all Ohio investors have benefited from the concentration limit, as discussed above.

2B. We also oppose a waiver process for Ohio's concentration limit for the purchase of non-traded REITs and BDCs that is limited to Ohio accredited investors, as some commenters have suggested.

Designing a waiver to the concentration limit for the purchase of non-traded REITs and BDCs based on the accredited investor definition would leave a significant number of Ohio investors vulnerable to the same risks that are discussed above. A significant number of investors qualify as accredited investors based solely on the retirement savings that they've amassed over a lifetime of work. These investors can ill-afford to put more than a modest amount of those assets into speculative and illiquid investments, such as non-traded REITs and BDCs.

Because the accredited investor definition relies on financial thresholds that have not been indexed to inflation for more than 40 years, the number of investors who qualify as accredited has grown significantly since the financial thresholds were set. Current accredited investors are therefore likely to have very different characteristics – and a very different risk profile – than the members of the one percent who made up the accredited investor population in 1982 when the standard was initially set.[5] For example, many accredited investors are unlikely to have the financial sophistication necessary to fully understand the risks associated with investing in speculative and illiquid investments, such as non-traded REITs and BDCs. Similarly, many accredited investors are unlikely to be able to withstand a total loss from a speculative investment, such as a non-traded REIT or BDC. If these investors were to invest in non-traded REITs or BDCs beyond the concentration limit and their investments fail, their financial security could be jeopardized. Moreover, experience shows that the sales of these assets are often targeted at older accredited investors. For example, the proposing release cites to the Securities Division's data with "citations to nearly 100 customer complaints and regulatory actions, highlighting devastating losses and hardships experienced by real people who are, by and large, accredited, elderly investors."[6]

3. Eliminating the concentration limit based on a waiver process in which an investor can invest up to *their entire life savings* in non-traded REITs or BDCs merely by signing a self-executing risk acknowledgment form will not protect Ohio investors.

The Securities Division has proposed a waiver to the concentration limit for the purchase of non-traded REITs and BDCs that would allow all Ohio investors, at all net worth and income levels, to invest *up to their entire life savings* in non-traded REITs or BDCs merely by signing a self-executing risk acknowledgement form. While a waiver form that is designed to warn investors of these products' risks before they purchase them beyond the concentration limit would be better than not providing these kinds of disclosures at all, it is unlikely that such an approach will meaningfully change investors' purchasing decisions.

In order to understand why a risk acknowledgment form won't protect Ohio investors, one must understand how these products are sold. Investors typically purchase non-traded REITs and BDCs based on the recommendations or advice of their financial professional, rather than based on investors' own due diligence of the potential risks and rewards of these products. As a result, investors are likely to defer to and rely on their "trusted adviser's" recommendations or advice to purchase these products. Any risk disclosures and acknowledgements, no matter how clear and informative, are unlikely to counteract the recommendations and advice they receive. In all likelihood, signing a risk acknowledgement form will as a practical matter, for most Ohio investors, become little more than a "check the box" paperwork exercise. Accordingly, it is

[5] If the financial thresholds were tied to inflation since 1982, the requirement for yearly income would have grown from $200,000 for an individual ($300,000 for a couple) to roughly $600,000 for an individual ($900,000 for a couple) and the net worth requirement would have grown from $1 million to $3 million.
[6] According to the Securities Division's data, 85 percent of the states that impose a 10 percent limit do so without an accredited investor carve-out. We agree that Ohio's accredited investors should not be denied safeguards available in most other merit states.

unlikely that such an approach will protect Ohio investors from the kinds of harms that have been prevented because of the existing concentration limit.

Conclusion

For the reasons discussed above, we urge the Securities Division to withdraw this proposed waiver to eliminate Ohio's concentration limit for the purchase of non-traded REITs and BDCs for all Ohio investors.

Given the risks and costs to retail investors regarding non-traded REITs and BDCs, the Securities Division should strengthen protections for Ohio investors by capping the *combined* amount of non-traded REITs and BDCs Ohio investors can purchase at 10 percent of their liquid net worth, from the current concentration limit that caps Ohio investor's purchase of these products up to 20 percent (10 percent in a non-traded REIT and another 10 percent in a non-affiliated BDC). Doing so would further limit the extent to which Ohio investors risk being defrauded, suffering significant and unrecoverable losses, and having their hard-earned money locked up for more time than they can bear because of these products and strengthen protections for older investors, who may be particularly vulnerable to devastating outcomes if they suffer significant losses or have their assets frozen.

Respectfully submitted,

Americans for Financial Reform Education Fund

Better Markets

Consumer Federation of America

Economic Policy Institute

Public Citizen

U.S. PIRG

Attachment

September 12, 2022

Via Email to nasaacomments@nasaa.org
NASAA
750 First Street, NE, Suite 1140
Washington, DC 20002

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

Dear Ms. Seidt and Mr. Heuerman:

On behalf of the undersigned organizations, we write in strong support of the proposed revisions to NASAA's Statement of Policy Regarding Real Estate Investment Trusts (REITs), which would enhance protections surrounding the offer and sale of non-traded REITs to retail investors.

The four primary revisions being proposed include: (1) an update to the conduct standards for brokers selling non-traded REITs, i.e., supplementing the suitability section with references to the Regulation Best Interest standard of conduct; (2) an update to the net income and net worth financial figures in the suitability section, i.e., adjusting upward to account for inflation occurring since the last adjustment; (3) the addition of a new standardized concentration limit to the suitability section; and (4) the addition of a new prohibition against using gross offering proceeds as an investment objective or strategy to make distributions.

I. Background on Non-Traded REITs

A Real Estate Investment Trust (REIT) is a company that owns – and typically operates – real estate or real estate-related assets. Investing through REITs can be beneficial as REITs can provide exposure to real estate without requiring an investor to actually buy or sell real property. There are different types of REITs, including those, like public company stocks, that are listed and traded on national securities exchanges. Non-traded REITs, on the other hand, are not listed or traded on national securities exchanges.

Non-traded REITs are often marketed and sold to retail investors, including retirement savers, as high-yield and predictable assets. However, these assets come with significant risks, including liquidity risk, valuation risk, income risk, and principal risk. In addition, non-traded REITs are extraordinarily high-cost investments that can drain retail investors' hard-earned money and underperform more liquid and diversified alternatives. Finally, non-traded REITs are rife with conflicts of interest, which expose retail investors to further harm. Given these risks and costs to retail investors, it is entirely appropriate for NASAA to update its policy regarding REITs to ensure that retail investors receive the protections they need and deserve.

- **Liquidity Risk and Valuation Risk**

Unlike traded REITs, which are listed and traded on public exchanges, non-traded REITs are sold directly by broker-dealers. Because non-traded REITs don't trade on exchanges, which provide real-time price transparency, non-traded REITs are extremely difficult to value accurately and fairly.

In addition, non-traded REITs can only be sold to other investors or back to brokers during limited times, usually only after the investor has held the asset for a year. Sales may be subject to additional significant and sometimes ad-hoc restrictions imposed by management. For example, at the onset of the pandemic, several non-traded REIT companies suspended redemptions.[7] According to a *Wall Street Journal* article at the time, "For many small investors, their inability to cash out their shares couldn't come at a worse time, with the economy reeling and millions joining the ranks of the unemployed."[8]

The extreme difficulty in valuing non-traded REITs and severe restrictions on their sale means they typically cannot be sold within a reasonable timeframe.[9] If investors are able to sell these investments at all, they often are forced to sell at substantially lower prices than they originally paid.

- **Non-traded REITs are Extraordinarily High-Cost Investments**

Non-traded REITs can drain retail investors' hard-earned money and underperform more liquid and diversified alternatives. According to research by Brian Henderson, Joshua Mallett, and Craig McCann at the Securities Litigation and Consulting Group published in 2015,[10] non-traded REIT investors pay up-front fees that average 13.2 percent of the purchase amount and in some cases are as high as 16.0 percent. These fees dramatically reduce the capital available to purchase portfolio holdings. A significant chunk of these costs goes to the brokers who recommend these products.

While non-traded REITs are often advertised as high-yield assets, their actual performance statistics tell a different story. According to the researchers' analysis, non-traded REITs underperform traded REITs by approximately 7.3 percent annually (11.3 percent for a diversified portfolio of traded REITs vs. 4 percent for the non-traded REITs sample they examined). Based on this underperformance, the researchers estimated that investors are at least $45 billion worse off as a result of investing in those non-traded REITs than they would have been if they had merely invested in a diversified portfolio of traded REITs. In fact, investors in

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[7] *See* Peter Grant, *Individual Investors Find Withdrawal Window Shut for Property Funds; Inability to cash out shares in nontraded REITs couldn't come at a worse time for many small investors*, **WALL** STREET JOURNAL**,** April 14, 2020, https://www.wsj.com/articles/individual-investors-find-withdrawal-window-shut-for-property-funds-11586865601.

[8] *Id*.

[9] *Id*. ("Other nontraded REITs have stopped redemptions because they have no way of putting a fair value on the real-estate assets in the funds or the shares that investors are trying to cash out.").

[10] Brian Henderson, PhD, CFA, Joshua Mallett, CPA, and Craig McCann, PhD, CFA, *An Empirical Analysis of Non-Traded REITs*, SECURITIES LITIGATION AND CONSULTING GROUP, 2015, https://www.slcg.com/files/research-papers/Henderson%20Mallett%20McCann%20non-traded%20REITs.pdf

non-traded REITs would have earned the same performance in short and intermediate term Treasury mutual funds without the high risks and extreme illiquidity of non-traded REITs.

When Mallett and McCann recently updated their analysis through 2019, their research confirmed that the high costs, relative underperformance, and conflicts of interest that retail investors suffer have persisted.[11] Specifically, they found that non-traded REITs as a group underperformed traded REITs by approximately 8 percent annually. The dollar losses from investing in non-traded REITs instead of traded REITs exceeded $75 billion as of December 31, 2019. The underperformance did not decrease over time.

- **Non-traded REITs are Characterized by Harmful Conflicts of Interest in Both their Management Structures and Sales Practices**

Non-traded REITs are rife with conflicts of interest both in how they are governed and how they are sold. Often the entities that manage and sell non-traded REITs are closely affiliated and controlled by the same top executives who divvy up the high upfront costs investors pay. These conflicted structures enable a systematic wealth transfer from retail investors who need to make every dollar count to the financial firms that create, manage, market, and sell these products.

The risks and costs that non-traded REITs impose on retail investors, coupled with the recent record sales of non-traded REITs,[12] necessitate an update to NASAA policy regarding REITs.

II. Proposed Revisions

The first revision recommended in this Notice is to update the REIT Guidelines by formally incorporating Regulation Best Interest's standard of conduct as well as any other updated conduct standards that are adopted by the NASAA jurisdictions as applied to brokers recommending these securities. This would make it clear that a broker must comply with currently applicable conduct standards, including Regulation Best Interest, and that otherwise complying with the policy requirements does not excuse a broker from complying with these conduct standards. These changes would help to ensure that brokers understand that they are subject to a standard that is higher than the previous suitability rule when they recommend and sell non-traded REITs. Further, these changes would help to clarify these conduct standards so that brokers are not under the misimpression that, merely because a client signs a statement acknowledging that they are qualified for the investment, the broker will be relieved from

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[11] Joshua Mallett and Craig McCann, *Further on the Returns to Non-Traded REITs*, THE JOURNAL OF WEALTH MANAGEMENT WINTER 2021, 24 (3) 113-127; DOI: https://doi.org/10.3905/jwm.2021.1.153.

[12] Beth Mattson-Teig, Non-Traded REITs Continue to Grab Record Capital Inflows, Wealth Management, May 23, 2022, https://www.wealthmanagement.com/reits/non-traded-reits-continue-grab-record-capital-inflows ("The non-traded REIT sector is on a blistering pace of fundraising. Capital inflows hit a record high of $36.5 billion last year, which is more than triple the $10.9 billion in capital raised in 2020, according to data from Robert A. Stanger & Co. Inc. The investment banking firm is forecasting an even bigger year ahead, and the market is off to a strong with $12.2 billion in capital raised during first quarter….Sponsors are devoting more resources to expanding sales channels to attract more retail investors to their platforms.")

complying fully with the standards of conduct. These changes would also help promote uniformity with federal securities law.

The second revision recommended in this Notice is to update the net income and net worth figures in the suitability section of the prospectus, by adjusting these figures upward for inflation. The current figures have not been updated since May 7, 2007. In the decade and a half since then, our nation has experienced significant inflation,[13] which has undermined the effectiveness of the current thresholds. If these thresholds are not raised, it is more likely that non-traded REITs will be sold to investors who cannot bear the risks of these products and these investors will be at greater risk of suffering harm. Indeed, we believe the REIT Guidelines should increase the net income and net worth thresholds beyond accounting for inflation in order to better protect retail investors from these products' risks.

The third revision recommended in this Notice is to add a specific concentration limit within the REIT Guidelines prohibiting an aggregate investment in the issuer, its affiliates, and other non-traded direct participation programs that exceeds 10% of the purchaser's liquid net worth. This concentration limit would help to ensure that investors do not lock up their entire portfolio in these risky, illiquid products. Instead, it would help to ensure that investors maintain adequate diversification among their investments such that they are not overly exposed to the risk of loss or illiquidity from a single investment or single type of investment. For these same reasons, we strongly support not providing a carve-out for "accredited investors," particularly given that the accredited investor standard has not been updated to reflect inflation since 1982.[14]

We also strongly support applying the concentration limit to all affiliates, including business development company (BDC) affiliates. Non-traded BDCs raise the same concerns as non-traded REITs, as both kinds of products can expose retail investors to liquidity risk, valuation risk, income risk, and principal risk,[15] in addition to being high-cost investments that can drain retail investors' hard-earned money and expose retail investors to harmful conflicts of interest. Also, like non-traded REITs, non-traded BDCs have experienced record sales recently.[16]

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[13] For example, according to the CPI Inflation Calculator on the Bureau of Labor Statistics website, $100 in May 2007 has the same buying power as $142.49 in June 2022. https://www.bls.gov/data/inflation_calculator.htm; *See also* Bureau of Labor Statistics, U.S. Department of Labor, The Economics Daily, Consumer prices up 9.1 percent over the year ended June 2022, largest increase in 40 years at https://www.bls.gov/opub/ted/2022/consumer-prices-up-9-1-percent-over-the-year-ended-june-2022-largest-increase-in-40-years.htm.

[14] *See* Commissioners Allison Herren Lee and Caroline Crenshaw, Joint Statement on the Failure to Modernize the Accredited Investor Definition, August 26, 2020, https://www.sec.gov/news/public-statement/lee-crenshaw-accredited-investor-2020-08-26

[15] *See* Evaluating Non-Traded BDCs, CNL Securities, https://www.cnlsecurities.com/core/fileparse.php/196/urlt/evaluating-ntbdcs.pdf; Business Development Companies: High Yields, Big Risks?, Schwab, March 4, 2022, https://www.schwab.com/learn/story/business-development-companies-high-yields-big-risks (stating that BDCs charge high fees and lack transparency); Testimony of Mercer E. Bullard, President and Founder, Fund Democracy, Inc. and Butler Snow Lecturer and Professor of Law, University of Mississippi School of Law, before the Subcommittee on Capital Markets, Securities and Investment Committee on Financial Services United States House of Representatives, "Legislative Proposals to Improve Small Businesses' and Communities' Access to Capital," November 3, 2017, https://bit.ly/2LwYKWn. ("One concern is that BDCs are characterized by extremely high fees.").

[16] *See Non-Traded Alts Raise $52 Billion Through May, Stanger Lowers REIT/BDC Sales Projections*, THE DIWIRE.COM, June 27, 2022, https://thediwire.com/non-traded-alts-raise-52-billion-through-may-stanger-lowers-reit-bdc-sales-

The fourth revision recommended in this Notice is to prohibit sponsors from reserving the right to use investor proceeds from an offering to fund regular cash distributions. We agree that funding regular cash distributions through a return of capital is an inefficient use of investor capital and is likely to mislead retail investors into believing they are receiving income when they are not. Restricting sponsors' ability to fund regular cash distributions with investor proceeds would reduce the likelihood of misleading retail investors about the sources of income and would enhance transparency into these products' performance.

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We appreciate your thoughtfulness in proposing these revisions to the REIT Guidelines and urge you to finalize these revisions without undue delay.

Respectfully submitted,

Americans for Financial Reform Education Fund

Better Markets

Consumer Action

Consumer Federation of America

Economic Policy Institute

Public Citizen

U.S. PIRG

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projections/ ("The non-traded BDC space continues its blistering pace of capital formation, up 174 percent from this time last year," said Randy Sweetman, executive managing director of Robert A. Stanger and Co.).