September 12, 2016

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NASAA Legal Department
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NASAA
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Re: Proposed Amendment to the NASAA Statement of Policy Regarding Real Estate Investment Trusts

Ladies and Gentlemen:

The Investment Program Association ("IPA") appreciates the opportunity to submit these comments in response to the Notice of Request for Public Comment Regarding Proposed Amendment (the "Proposed Amendment") to the North American Securities Administrators Association ("NASAA") Statement of Policy Regarding Real Estate Investment Trusts, dated July 27, 2016 (the "Notice").

I. BACKGROUND ON THE INVESTMENT PROGRAM ASSOCIATION

The IPA was formed in 1985 to provide effective national leadership for the direct investment industry. The IPA supports individual investor access to a variety of asset classes not correlated to the traded markets[1] that have historically been available primarily to institutional investors. The funds which invest in these asset classes include publicly registered, non-listed real estate investment trusts ("NL REITs"), publicly registered, non-listed business development companies ("NL BDCs"), and other publicly registered, non-listed direct participation programs ("Other DPPs," and collectively with NL REITs and NL BDCs, "Public Programs"). See Appendix A for an overview of publicly registered, non-listed REITs. For 30 years the IPA has successfully championed the growth and improvement of such products, which have become increasingly important to financial professionals and investors alike. Public Programs are now held in more than 2.8 million investor accounts. Today, Public Programs function as a critical component of effectively diversified investment portfolios and serve an essential capital formation function for national, state, and local economies.

[1] Asset classes that are not correlated to the traded markets generally do not move in parallel with the traded markets. This results in a type of diversification that assists in reducing the portfolio risk that results from traded market volatility.

The IPA serves the investment community through advocacy, collaboration and education regarding these Public Programs. IPA members include 165 product sponsors, asset management companies, broker-dealers and direct-investment service providers, including major national accounting and law firms and national, regional, and independent broker-dealer firms. Collectively, these members service financial and direct investment assets in virtually all investment categories, including Public Programs representing over $114 billion of assets under management.[2]

The IPA establishes and encourages best practices on behalf of the investing public, such as:

- Promoting uniform and comparable reporting of product performance information;

- Standardizing valuation and financial metric reporting among direct investment products for ease of comparison by the investing public and other users of the information;

- Enhancing overall product transparency beyond what is required to be disclosed in filings with the Securities and Exchange Commission ("SEC");

- Working directly with federal and state regulators (e.g., the SEC, the Financial Industry Regulatory Authority, Inc. ("FINRA")[3] and various members of NASAA) to help create consistent and transparent communications and regulations for Public Programs;

- Raising investor understanding of Public Programs and their potential to address individual financial goals through educational programs; and

- Training financial advisors to enhance their knowledge of Public Programs and the appropriate role of these products in client portfolios.

Representatives of the IPA and of several of the IPA member organizations were each invited by the NASAA DPP Project Policy Group (the "Project Group") to participate in separate discussions with the Project Group on September 16 and 17, 2015, in Baltimore, Maryland. These discussions focused on the Policy Group's draft amendments to NASAA's Statement of Policy Regarding Real Estate Investment Trusts (the "REIT Guidelines"). Subsequent to those meetings, the IPA contacted several members of the Policy Group suggesting that a joint task force be formed in order to undertake a mutually beneficial dialogue to identify common objectives, share industry information regarding current practices and perceived needs, explore alternative paths to achieve appropriate investor protections, and generally further the dialogue between NASAA policymakers and industry participants. The IPA believed that such a joint task force would enable the IPA and NASAA to coordinate NASAA's efforts to produce amendments to the REIT Guidelines that are appropriate, implementable and adequately address the best interests of investors in Public Programs. Further, the establishment of such a joint task force

[2] A complete list of the IPA's members is available at: http://www.ipa.com/membership/#directory.

[3] FINRA is an independent; self-regulatory organization authorized by Congress to protect investors by ensuring that the securities industry operates fairly and honestly. (http://www.finra.org)

would create a constructive framework for an effective dialogue between NASAA policymakers and industry participants as NASAA seeks to establish new guidelines or amend other existing guidelines for Public Programs. The IPA continues to offer its active participation in such a joint task force if NASAA wishes to pursue this approach for future proposals and to refine the Proposed Amendment and urges the formation of such a joint task force to ensure that any amendments to the REIT Guidelines reflect the input of industry participants, are carefully tailored to achieve NASAA's objectives and can be implemented by industry participants.

The IPA respectfully submits this letter, which provides important information and the collective comments and recommendations of the industry regarding any final amendments to the REIT Guidelines with respect to concentration limits. The IPA is providing recommendations related to (i) the current state of the NL REITs industry and the need for and timing of any NASAA concentration limit in light of the product innovation within the NL REIT industry and the recent developments in the regulatory regime related to fiduciary standards; (ii) the IPA's comments and concerns regarding the requirements and policy implications of the Proposed Amendment; and (iii) the IPA's recommendations for any Proposed Amendment of the REIT Guidelines. Capitalized terms used and not otherwise defined herein have the meaning ascribed to them in the REIT Guidelines.

II. EXECUTIVE SUMMARY

The primary purpose of the Proposed Amendment is to implement a "concentration limit" that would impose a cap on an investor's aggregate investment in an NL REIT, its Affiliates and other NL REITs to no more than 10% of an investor's liquid net worth. The IPA respects and shares the desire of NASAA and the various NASAA jurisdictions to protect investors from practices that are not in their best interests and ensure that NL REITs are recommended to investors based on appropriate standards of financial and personal suitability and consistent with the investment goals of the investors. The IPA believes that sufficient safeguards are in place at the federal, state, and broker-dealer levels to minimize the risk of investor harm and provide adequate recourse in those rare instances in which an NL REIT is sold to an investor which is unsuitable or inconsistent with the investor's goals. Therefore, the IPA respectfully submits that the application of investment concentration limitations to NL REITs is inappropriate in light of recent regulatory developments and innovative developments proactively adopted by the industry to ensure investor suitability and consistency with the investor's investment objectives. A uniform, one-size-fits-all-investors approach is unnecessary, ignores the distinct investor-specific factors that lead to a reassured suitability determination, and may even be harmful under the current regulatory regime. In support of these views, this letter will address (i) the current state of and innovation in the NL REIT industry and the need for and timing of any NASAA concentration limit, taking into consideration the recent developments in the regulatory regime related to fiduciary standards; (ii) the IPA's comments and concerns regarding the requirements and policy implications of the Proposed Amendment; and (iii) the IPA's recommendations for the Proposed Amendment or any further contemplated revisions of the REIT Guidelines.

A. Current State of the Industry

Since the 1980s, NL REITs have evolved from their predecessor forms and structures to provide improved liquidity, more transparency and independent valuation discovery, enhanced governance, more investor-friendly structures and compensation provisions, greater scale and associated financial strength, efficiency, strategic optionality and professional management of the distinct asset classes managed by NL REITs. IPA believes that NL REITs have demonstrated successful investment performance and achievement of investment objectives which have clearly benefitted investors. The IPA submits that these industry-led improvements diminish the need for a uniform concentration limit.

In addition, considerable regulatory protections, including limits on the availability of NL REITs to investors of modest income and net worth and mandated broker-dealer determinations of suitability, already exist at the federal and state levels. These protections go far beyond the regulatory oversight of other alternative investment products. Further, new regulations promulgated by the U.S. Department of Labor ("DOL"), the so-called "Fiduciary Rule," were finalized during the Project Group's deliberations regarding imposition of a concentration limit. This new rule, and the anticipated introduction by the SEC in the fall of 2016 of a coordinating fiduciary rule for all retail accounts, addresses many of the potential concerns giving rise to the perceived need for a concentration limit and provides significant additional safeguards for investors.

B. IPA Comments and Concerns Regarding the Proposed Amendment

The Notice calls for comments to the Proposed Amendment, which would implement a concentration limit for all NL REITs. The preamble to the Proposed Amendment indicated that the goal of the Policy Group in proposing the amendments is to "*move to a more uniform concentration standard across jurisdictions.*" The Notice states that the Proposed Amendment "*would add a uniform concentration limit…*" and proposes the following changes to the REIT Guidelines:

- the addition of a requirement that sponsors establish a "*minimum concentration limit*" for Persons who purchase Shares in a REIT for which there is not likely to be a substantial and active secondary market;

- an explicit listing of 14 qualitative and quantitative factors that each Administrator may consider in evaluating the concentration limit proposed by the sponsor;

- a limit of a Person's aggregate investment in the REIT, its affiliates, and other non-traded REITs to no more than 10% of the Person's liquid net worth (defined as "that portion of net worth consisting of cash, cash equivalents, and readily marketable securities"), subject to an exclusion from the limit for Persons deemed Accredited Investors under the income or net worth standard of Rule 501 of Regulation D;

- the ability of each jurisdiction to modify any portion of the concentration limit (i.e., require a different concentration limit) based on each Administrator's assessment of the 14 factors or, presumably, based on different income thresholds;

- the addition of a requirement that an NL REIT prospectus contain disclosure acknowledging that the concentration limit does not satisfy the independent suitability determination required under the REIT Guidelines, existing administrative rules or self-regulatory organization rules when selling Shares;

- the addition of a requirement of the sponsor and each person selling shares to maintain records of the information used to establish compliance with the concentration limit for a period of six years; and

- the addition of a requirement to disclose in the final prospectus the responsibility of the sponsor and each person selling Shares to make "every reasonable effort" to determine the purchaser meets the concentration standard based on information provided by the shareholder regarding the shareholder's financial situation and investment objectives.

The IPA's primary concerns with respect to the Proposed Amendment relate to the following issues: (i) the application of the concentration limit to the total of a person's investments in the "REIT, its affiliates, and other non-traded REITs" and the potential of this definition to capture investments in listed or privately issued securities and investments unrelated to real estate and to prevent the flow of capital to programs producing the best risk-adjusted returns, thereby increasing investor risk and potentially resulting in investment limitations being imposed on exempt securities offerings; (ii) the determination of a concentration limit based solely on liquid net worth as opposed to total net worth (excluding home, furnishings and automobiles) thereby limiting the ability of investors to achieve diversification for their entire portfolio; (iii) the absence of definitive income and net worth exemptions from such a standard, as each Administrator may independently evaluate any standards and any exclusion proposed by the sponsor; (iv) the need for additional clarifications with respect to the new record-keeping and disclosure requirements; and (v) the imposition of concentration limits during a period of substantial regulatory change with respect to the fiduciary obligations of financial advisors and broker-dealers.

The IPA also believes that the Proposed Amendment's one-size-fits-all-investors ignores the financial advisor's duty to evaluate suitability based on the financial condition and factors specific to that investor, which requires the financial advisor's familiarity with each investor's personal financial situation, existing portfolio, and level of sophistication, investment goals, and risk tolerance, and instead imposes a static, one-variable test. The IPA respectfully submits that the Proposed Amendment could have a chilling effect on investment including a negative impact on the ability of ordinary (*i.e.,* non-high net worth) investors to reduce the risk profile of and properly diversify their investment portfolios across non-correlated asset classes. Overly restrictive regulation of the securities of NL REITs may have the unintended consequence of forcing investors into investing in products with less oversight and transparency than NL REITs because the benefits of NL REITs and Public Programs in general are not easily replicable or readily available to the retail investment community in other investment products. As a result, investors may face greater, rather than less, risk as a result of the implementation of the Proposed Amendment.

C. Recommendations for Proposed Amendment

Although the IPA and its members believe concentration is one appropriate consideration in determining the appropriateness of a NL REIT in an investor's portfolio, such determination should be based on facts and circumstances specific to each individual investor. These factors go beyond a simple net worth and income percentage and should appropriately include such customer-specific considerations as risk tolerance, investment experience and sophistication, investment time-frame, nature of wealth holdings and level of correlation between the various asset classes held (both liquid and illiquid), family situation and outlook, financial and lifestyle objectives, etc. Further, if NASAA desires to proceed with the Proposed Amendment reflecting the imposition of a concentration limit based on only one variable (liquid net worth), then the IPA recommends that it delay such consideration until after the positive impact of the DOL Fiduciary Rule can be assessed and after the SEC proposes its fiduciary rules. Finally, if NASAA nevertheless intends to proceed now to amend the REIT Guidelines to include a concentration limit, the IPA believes that the basis of the concentration limit should be investor total net worth (exclusive of home, home furnishing and automobiles) at the time of the investment, and that the concentration limit should be applied solely to the investment in an individual NL REIT (exclusive of investments made via a distribution reinvestment plan) and not to all NL REIT investments and investments in Affiliates.

The following pages provide more in-depth details regarding the state of the NL REIT industry, the IPA's comments and concerns with respect to the Proposed Amendment and the IPA's recommendations for amendment of the REIT Guidelines. For ease of reference, this letter is organized as follows:

III. STATE OF THE INDUSTRY

A. Evolution of NL REITs and Investor-Friendly Features

In response to competition, market forces, and changing regulation, NL REITs have implemented a number of investor-friendly features. Certain of these are discussed below.

i. Introduction of Liquidity Features.

NL REITs are marketed to and intended for investors with no immediate need for liquidity in their investment. NL REITs typically have limited lives and seek a liquidity event within a five to ten-year holding period. Such a liquidity event can include a listing of the company on a national securities exchange, a merger with an existing exchange-traded company, or a sale of the assets of the company. All three liquidity events are designed to provide a final return of the capital invested and any gains after the investor has enjoyed the income generated during the term of the investment. To provide some liquidity prior to a targeted liquidity event, NL REITs now offer share redemption programs ("SRPs") for investors, including those who confront unexpected financial needs. The typical NL REIT SRP will accommodate the redemption of 5% of the total number of its shares outstanding each year. A form of NL REIT that is rapidly gaining momentum in equity fundraising, the daily net asset value ("Daily NAV") REIT, will accommodate the redemption of up to 20% of the REIT's net asset value each year—indicating an on-going trend toward the provision of greater liquidity among NL REITs. Daily NAV REITs are similar to mutual funds in that they are perpetual life and provide daily pricing at which shares can be purchased or sold (subject to the aforementioned 20% aggregate annual redemption limitation). Under normal market conditions, these SRPs generally meet the redemption needs of investors. In 2015, 98.3%[4] of all the shares submitted for redemption via the SRPs of 60 operational NL REITs were redeemed.[5]

ii. Improved and Transparent "Price" Discovery.

Modern NL REITs provide investors with significant "price" (*i.e.*, value) transparency in accordance with both regulatory requirements and industry valuation and disclosure guidelines issued by the IPA. FINRA Rule 2310, which governs the recommendation of a Public Program to an investor by a broker-dealer, stipulates that a broker-dealer may not sell a publicly-registered Public Program security unless the issuer of the Public Program agrees to provide a valuation of its underlying assets and liabilities in its annual report (or other public filing). Recent changes to NASD Rule 2340 which became effective in April 2016 (during the period of deliberation by the Project Group) impose additional transparency requirements for Public Programs relating to the reporting of their values on customer account statements and requiring the use of valuation methodologies consistent with industry standards and practices and the

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4 Source: Robert A. Stanger & Co., Inc. analysis of data disclosed in Forms 10-K dated December 31, 2015 regarding SRP transactions during 2015 for 68 operational NL REITs.

5 Of 68 registered or closed NL REIT programs, the percentage of fulfilled redemption requests could only be calculated for 60 programs. Three legacy programs suspended their SRP prior to 2015 and five other programs are fulfilling redemptions requests only in the event of death or disability.

material involvement and confirmation of such asset valuations by independent valuation experts.

In addition, the IPA issued "*IPA Practice Guideline 2013-01: Valuations of Publicly Registered Non-Listed REITs*." This guideline sets forth standards relating to the determinations of an NL REIT's value (net asset value), methodology, independence of valuations, management of the process of conducting valuations, and enhanced reporting and disclosures relating to valuations. This guideline adopted the basis for valuation reporting used by institutional real estate investors, with the valuation determined consistent with the definition of fair value under generally accepted accounting principles ("GAAP").

iii. Enhanced Governance and Reductions of Conflicts of Interest.

As explained more fully below, NL REITs typically have more robust investor protections than the publicly offered real estate partnerships of the 1980s and 1990s due to improved governance provisions and limitations on conflicts of interest. For example, NL REITs' boards of directors are elected by shareholders and typically require majority approval by independent directors for actions that impact shareholder rights, strategic transactions, or transactions involving affiliates. Additionally, the structures and duties of boards of directors of NL REITs are dictated by state corporation or trust laws and the REIT Guidelines.

iv. Enhanced Professional Management Expertise.

NL REITs have attracted "institutional quality" professional asset management companies with exceptional qualifications in their areas of focus. For example, the Blackstone Group, a company with over $350 billion of assets under management and deemed by most industry observers to be the leading global real estate asset manager, recently entered the NL REIT market, filing a registration statement for the $5 billion offering of its first NL REIT in August 2016. Such institutional asset management companies have recognized the growing use of these products by retail investors, and the ability of these products to enable the investor, in consultation with the financial advisor, to determine the most appropriate asset mix of the account. This growing influx of such highly experienced and successful management organizations has contributed to the quality and growth of investment in NL REITs.

v. Greater Efficiencies of Scale, Financial Strength and Strategic Options.

NL REITs today are significantly larger than their predecessor products. For example, the amount of equity invested in the 45 fully liquidated NL REITs that comprised the performance study discussed in section III.C.ix averaged approximately $1.36 billion over the life of the NL REITs. Initial offerings typically register between $1 billion and $2 billion of securities. It is not uncommon for NL REITs to have upwards of $3 billion of equity investment under management. These larger-sized, asset-based enterprises provide enhanced operational efficiencies and have more financing resources and options. In addition, companies of this size are more flexible when considering liquidity events because they can choose to sell their assets over time (*i.e.*, self-liquidate), evaluate potential merger partners that meet the strategic goals of the NL REIT, or grow to the critical size necessary to list their securities on a national exchange. These greater efficiencies, in turn, have put downward pressure on costs and fees associated with NL REITs.

vi. Momentum of Industry toward New Multi-Share Class Products With Significantly Lower Front-End Sales Commissions.

The NL REIT industry is in the midst of a fundamental change in the structure of front-end sales commissions—a transformation akin to what occurred in the 1970s and 1980s with the advent of asset-based distribution fees, or trailing commission fees, for mutual funds. Currently, 31 of 35 NL REITs in registration or effective for sale offer a share class with front-end sales commissions of 3% or less. These programs increasingly provide for ongoing shareholder servicing fees that require the continued provision of ongoing account maintenance and other services to the investor and are subject to FINRA limitations regarding total underwriting compensation. (See Section III.E herein for a more complete description of these new and evolving, investor friendly structures.)

vii. Supporting Statistics.

The aforementioned and other reasons have propelled NL REITs to become an increasingly essential and beneficial investment for retail investors, including retirement investors, as evidenced by these statistics:

- A cumulative total of over $131.1 billion has been invested in NL REITs since 2000 through year-end 2015.
- Annual investment in NL REITs has increased from $706 million in the year 2000 to a peak of approximately $20 billion in 2013, and has averaged $10.6 billion per year for the past ten years.
- Of the $20 billion invested in NL REITs during the year 2013, 43% was invested by individual retirement accounts ("IRAs").
- NL REITs have returned over $67 billion to investors via liquidity events.
- NL REITs currently have over $90 billion of real estate assets under management.
- Over 31,000 financial advisors regularly recommend NL REITs for their clients' portfolios.
- NL REITs were held in over 2.8 million investor accounts, including 1.5 million IRA accounts as of December 31, 2015 the number of IRA accounts invested in NL REITs had doubled since 2011.
- NL REITs provided over $4.7 billion of income distributions to investors in 2015, of which over $2.1 billion went to IRA accounts.

- Approximately 30% of all public equity issuances (including initial and secondary offerings) that financed the purchase, development and improvement of U.S. commercial real estate by investment entities between 2000 and 2015 have been by NL REITs. During the same period, NL REITs raised over $131.1 billion compared with $39.8 billion raised in exchange-traded equity REIT IPOs. These facts confirm not only the significance of NL REITs relative to exchange-traded public REITs, but also their important role in real estate capital markets and the economy as a whole.

- Capital formation by NL REITs over the past 10 years has produced significant commercial real estate investment across the country. These investments also support thousands of jobs in NASAA-member states in the health care facilities, apartment buildings, shopping centers, office buildings and industrial warehouses that the public use and visit every day. The following table demonstrates this positive impact on commercial real estate and economic activity, employment and tax receipts using the Project Group states as an example. (Note: Data based on IPA research of all NL REIT 10K SEC filings over a period of 10 years, between 2003 and 2013.)

State	# of Properties	Square Footage	Investment
Alabama	88	4,059,113	$585,789,000
Kentucky	51	3,863,004	$421,087,000
Maryland	31	3,617,627	$1,132,445,000
Massachusetts	66	10,292,486	$1,657,260,000
New Jersey	52	5,766,138	$1,968,118,000
New Mexico	14	151,812	$63,848,000
Ohio	123	10,574,047	$1,460,897,000
Washington	29	3,576,979	$998,198,000
TOTAL	**454**	**41,901,206**	**$8,287,642,000**

B. Evolution of the Industry to Address Liquidity Considerations

While there is an informal secondary market for interests in many NL REITs, this market cannot be described as active or efficient. Because NL REITs are not initially listed on a national securities exchange, they are appropriately described as "illiquid." This, however, does not mean that NL REITs are fully illiquid.

NL REITs are designed for, and the offering documents clearly specify they are only appropriate for, an investor with a long time horizon who has no immediate need for the capital invested. NL REITs do indeed allow for early redemption of investors, although they are clearly marketed as illiquid securities with intermediate to long-term holding periods and are subject to strict suitability requirements. While terms and limitations may vary, it is typical for NL REITs to offer SRPs to provide investor liquidity in advance of the occurrence of a final liquidity event, such as a stock exchange listing, merger or sale of the assets. These SRPs are limited: they are often legally required by the SEC to impose caps on the number of shares to be acquired (*e.g.,* a maximum percentage of the number of shares outstanding). While SRPs are typically discretionary on the part of the NL REIT, most NL REITs have a record of honoring redemption requests under normal economic and capital market conditions.

NL REIT sponsors are aware that while an investor may make a NL REIT investment without an immediate need for access to the capital invested, the investor's personal financial circumstances may change. The vast majority of NL REITs provide liquidity for shareholders that seek it upon exigent circumstances. SRPs typically offer liquidity through the repurchase of up to 5% of outstanding shares on an annual basis. As previously observed, Daily NAV REITs, which are gaining momentum in equity fundraising, will accommodate the redemption of shares representing up to 20% of the REIT's NAV each year—indicating an on-going trend toward the provision of greater liquidity among NL REITs. NL REIT SRPs typically require a minimum hold of one year, with certain exceptions for redemptions upon the death or disability of the investor.

NL REITs, with the exception of perpetual life Daily NAV REITs, also seek to provide complete investor liquidity at the end of their terms. For example, NL REITs may seek to list their shares on a national securities exchange, effect a merger whereby shareholders would receive cash or listed securities, or effect a sale of all or substantially all of their assets.

The fact that NL REITs do not offer the full liquidity associated with exchange-traded securities and mutual funds is not a sufficient reason to impose an arbitrary one-size-fits-all-investors concentration limit on this entire investment category. In fact, the attribute of not being exchange-traded and immediately liquid is the very reason why NL REITs are being included in investment portfolios in general, and retirement portfolios in particular. As retirement accounts are generally designed for long-term holding periods that desire periodic income generation, there is no reason why a less liquid investment would be *per se* improper above a certain concentration. In fact, the lack of immediate liquidity discourages "churning" and "market timing" and further reduces volatility and the investment portfolio's correlation to the stock market.

Further, the inherently illiquid nature of real properties dictates that any real estate investment vehicle designed to provide the portfolio benefits of diversification and low correlation with exchange-traded financial assets, whether it be an institutional separate account, or commingled fund or an NL REIT, must by its nature have limited liquidity. Therefore, retirement investors seeking an optimally diversified portfolio cannot achieve that objective using solely exchange-traded REITs or mutual funds which invest in exchange-traded REITs and real estate companies.

Finally, the potential portfolio volatility that, of necessity, accompanies portfolios of directly or indirectly owned exchange-traded securities may result in investors receiving substantially lower proceeds from a liquidation of their investments at times of depressed market conditions, thereby jeopardizing the future income-generating potential of their retirement savings and compromising their lifestyles.

C. NL REITs Complement Retail Investment Objectives

NL REITs possess attributes that satisfy retail investment objectives in general and retirement investment objectives in particular. Because of this, these programs have rapidly gained advocates among financial advisors and investors. In particular, NL REITs have the following positive characteristics:

i. Provide Superior and Reliable Income Distributions.

NL REITs are typically designed to provide a significant majority of their returns in the form of a stable stream of income, which many investors desire and can complement a portfolio that otherwise holds securities focused on appreciation. A REIT must distribute substantially all of its taxable income to avoid certain tax penalties. Because of this, an NL REIT is an ideal investment for an investor seeking current income, and this attribute is a primary reason for the attractiveness and growth of the asset class.

ii. Focus on Current Return, Not Speculative Growth.

Because NL REITs typically have investment objectives of providing a majority of return in the form of current income, retail investors using NL REITs can limit their exposure to the risks inherent in more aggressive or speculative products that have capital appreciation as their investment mandate and therefore seek a rapid growth of capital. These products clearly magnify risk and the potential loss of investor capital and are not subject to any concentration limits.

iii. Provide the Potential for Inflation Protection.

Inflation is a significant risk to an investor's current lifestyle and retirement income and the purchasing power of savings. Unlike bond and fixed-income portfolios, in which the purchasing power of invested capital can be eroded by inflation, real estate investments can act as an inflation "hedge" and provide increasing cash distribution rates and capital protection through appreciation of value of the underlying assets.

iv. Avoid Exposure to the Volatility of Traded Securities Markets While Providing a Measure of Liquidity.

By investing directly in real assets and non-traded investments, NL REITs help investors avoid over-concentrating their portfolios in exchange-traded securities or pooled investment vehicles that invest in exchange-traded securities, thereby helping diversify investor portfolios and reduce the volatility and market risks associated with concentrating the portfolio in too many of these exchange-traded securities. Indeed, it is noteworthy that major institutional pension plans historically have utilized investment strategies that call for investment in both exchange-traded REITs and non-traded real estate investments, with a substantial majority, or concentration, of their real estate investment asset class in non-traded form. This strategy helps insulate institutional portfolios from the volatility which can occur in exchange-traded securities markets. For example, the RMZ Price Index of exchange-traded REITs has experienced a one-day decline as high as 19.7% and value swings exceeding 5% on 4.6% of all trading days in the past ten years (approximately equivalent to one such swing every 20 trading days).

It is important to note that volatility of this magnitude is not unique to exchange-traded REITs but applies to numerous subcategories of exchange-traded securities that are not subject to any concentration limits.

For example, during the 10-year period ending 2013 and excluding the year of the financial crisis (2008) 39.5% of all publicly-traded equity securities experienced an annual loss of trading value, and the average of such annual value declines was 25.3%. Approximately one quarter of the securities with an annual loss experienced value declines of greater than 50%.[6] Yet, publicly-traded equity securities are not subject to any concentration limits.

Historically, such volatility of exchange-traded securities markets has tended to induce retail investors to sell securities at times of declining market prices and purchase securities at times of increasing market prices – i.e. to transact at precisely the wrong time. Morningstar's Investor Return metric demonstrates that investors with access to full liquidity typically achieve results well below market averages due to poorly timed buy and sell decisions, particularly when the markets are volatile. The long-term result of these typical, but ill-advised timing decisions is sub-par investor savings. NL REITs mitigate the impact of volatility-induced losses while still offering some liquidity to investors, combined with greater price stability.

Volatility can be particularly detrimental to retirement investors whose retirement portfolios are concentrated in exchange-traded securities and pooled investment products that invest in exchange-traded securities. Retirement investors may begin regular withdrawals to sustain their lifestyles or comply with Internal Revenue Service ("IRS") required minimum distributions. For these investors, the value of their portfolio may have been temporarily depressed due to market volatility yet nevertheless they are required to begin taking these distribution withdrawals. The distribution withdrawals will represent a greater proportion of their retirement savings, thereby reducing the future income-generating potential of their retirement savings and compromising their lifestyles.

v. <u>Enable the Assembly of More Effectively Diversified, and Therefore More Stable, Investment Portfolios.</u>

NL REITs provide individual investors with access to "direct investments" which for years have been a fundamental component of the investment portfolios of institutional pension plans and endowments. These institutional investors, operating under "prudent investing" principles, have long recognized the tenets of Modern Portfolio Theory. This theory, first described by the Nobel prize-winning economist Harry Markowitz and subsequently confirmed through observation and quantitative analysis, states that investors can achieve superior risk-adjusted returns by combining assets that have different risk characteristics. This combining of assets can result in a portfolio with greater potential for return, and no corresponding increase in risk, than a portfolio

6 Sources: Bloomberg Financial, Robert A. Stanger & Co., Inc.

not so combined. A key determinant of the amount of risk reduction is not just the number of assets combined, but more importantly their "correlation." Two asset classes whose returns move in parallel (*i.e.*, when one goes up, the other goes up) are said to have a positive correlation; if their returns move in opposite directions they have a negative correlation. Markowitz demonstrated that anything less than perfect positive correlation can potentially reduce risk.[7]

NL REITs provide retirement investors with the opportunity to diversify and stabilize their portfolios of financial assets and thereby improve their risk/return profile in the same way that professionally managed institutional pension and endowment plans do – by investing in real assets operated by professional management organizations that specialize in that asset class. These assets have historically shown low correlations with exchange-traded equities, and therefore are recognized as effective diversifiers.

It is also noteworthy that individual NL REITs typically provide substantial "internal diversification" similar to the diversification provided within the portfolios of mutual funds. For example, among 41 NL REITs representing over $50 billion of total equity investment, the average NL REIT's portfolio held interests in 92 properties.[8]

vi. <u>Provide Retail Investors Access to Investments that are Similar to Alternative Investment Strategies that Dominate the Portfolios of U.S. College and University Endowments.</u>

Inspired by the success of the Yale University Endowment's employment of alternative investments, many other educational institutions have been pursuing the same alternative investment strategy. As of June 2015 the allocation of all public and private educational institutional endowments had committed a weighted average of 52% of invested assets to alternative investment strategies, compared with 16% to domestic equities, 19% to international equities, 9% to fixed income, and 4% to short-term securities or cash equivalents.[9]

vii. <u>NL REITs Can Reduce not only Portfolio Investment Risk, but also "Sequencing Risk," Thereby Enhancing the Wealth Available for Retirees.</u>

Sequencing risk (*a.k.a.,* path dependency risk) relates to getting the "right" returns but in the "wrong order." An example of "sequencing risk" would be volatility occurring in a portfolio at the time the accountholder seeks to withdraw funds, i.e. in retirement rather than earlier when volatility in the portfolio would pose less of a risk because the funds would not need to be withdrawn at that time. Academic studies show that such risk can result in wealth outcomes that vary by almost 300% for portfolios which generate identical average investment returns.[10] Volatility later in a worker's retirement accumulation period or at the outset of the withdrawal

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7 Burton G. Malkiel, *A Random Walk Down Wall Street*, p 190, W.W. Norton & Company (9th edition 2007).

8 Source: Robert A. Stanger & Co., Inc. based on analysis of Forms 10-K as of December 31, 2015 filed with the SEC.

9 Source: National Association of College and University Business Officers (NACUBO), 2015 NACUBO-Commonfund Study of Endowments.

10 GMO LLC White Paper, *Sequence Risk and Its Insidious Drag on Retirement Wealth*, August 2015.

phase can erode otherwise sufficient savings. Portfolios including NL REITs can reduce overall volatility and also help stabilize income – attributes which can mitigate sequencing risk.

viii. NL REITs Represent Long-Term Investment Solutions that Match the Long-Term Savings and Income Needs of Retirement and Pre-Retirement Savers.

Because NL REITs, like all REITs, are required to distribute no less than 90% of their taxable income to avoid incurring a tax penalty, they represent an ideal investment for income-oriented investors such as retirees or investors nearing retirement age.

ix. Successful Investment Performance.

In a study of 45 nontraded REITs that have provided full-liquidity to their common shareholders from 1997 through October 2015, published in January 2016, Blue Vault Partners in collaboration with the Real Estate Department at the Terry College of Business, University of Georgia, found the following:

When comparing nontraded REIT full-cycle returns to traditional investment market indices, the average annualized returns on nontraded REITs in the study were 6.92% (without DRIP) and 7.50% (with DRIP), compared to an average annual total return for the S&P 500 Stock Index of 8.35% and average annual returns of the Intermediate-Term Treasury Fund benchmark of 5.44% over matched holding periods. Of the full-cycle REITs 21 (47%) outperformed the S&P 500 Index and 33 of 45 (73%) outperformed Intermediate-Term U.S. Treasury Bonds. During this holding period, these NL REITs typically provided investors with stable income in the form of monthly or quarterly cash distributions.[11]

D. Current Investor Protections

As is described in greater detail below, all NL REITs and those who sell them are subject to significant levels of regulation by the SEC, FINRA and the securities regulators of the states in which those products are sold.

i. Robust Regulation Beyond That of Many Products Available to Retail Investors Without the Imposition of Concentration Limits.

Although the regulations differ depending upon the specific product, in general, the regulation of NL REITs addresses topics such as: disclosures (e.g., product details, risks, conflicts, fees, and expenses); portfolio composition and permitted leverage; director qualifications and independence; limitations on transactions with affiliates; limitations on distribution costs, and organizational and operating expenses; limitations on compensation payable to the general partner or external advisor and affiliates which that provide management services related to the acquisition, operation, and disposition of the assets of the investment entity; and the imposition

[11] "Fourth Edition Nontraded REIT Full Cycle Performance Study," Blue Vault Partners, LLC; Dr. Richard Martin and James Stevens, Terry College of Business, University of Georgia, January 25, 2016

of investor suitability standards (e.g., minimum investor income and net worth requirements; a requirement that broker-dealers selling the products assess the suitability of the products for the investor; and limitations observed by broker-dealers on the amount of net worth an investor may invest in a particular category of product, commonly sponsored products, and/or individual products).

In addition, unlike many of the products which that are not subject to concentration limits, NL REITs: (i) are almost entirely marketed through broker-dealers and, therefore, cannot be purchased directly by the investor without the involvement, product due diligence, and investor suitability evaluation performed by a broker-dealer; and (ii) are subject to review in all states and "merit review" in approximately 25 states which involve subjective determinations by the individual state regulators as to the fairness of the offering to investors in that state.

ii. Existing Federal Regulation of NL REITs.

(a) Current Federal Regulatory Regime.

REITs, including traded REITs and NL REITs, are a category of investment vehicles created by Congress through the enactment of the Real Estate Investment Trust Act of 1960. REITs were created to provide to all investors access to the benefits of commercial real estate investment, which benefits previously were available only to wealthy individuals or to large institutional investors. Offers and sales of interests in NL REITs are registered under the Securities Act of 1933, as amended (the "1933 Act") and with the state securities regulators of each state in which the NL REIT publicly offers its shares. In addition, NL REITs must file with the SEC (and make publicly available) frequent, detailed periodic and current reports, such as Forms 10-Q, 10-K and 8-K, as well as proxy statements pursuant to the Securities Exchange Act of 1934, as amended (the "1934 Act"). NL REITs that invest primarily in real property are not investment companies. NL REITs that invest primarily in mortgage loans or other real estate-related securities operate pursuant to an exclusion from being deemed an "investment company" under the Investment Company Act of 1940, as amended (the "1940 Act"). The entity that serves as the external management to the NL REIT is typically a professional real estate management company, which may be required to register as an "investment adviser" under the Investment Advisers Act of 1940, as amended, depending on the assets to be invested in by the NL REIT and the investment strategy to be pursued.

REITs must also qualify under IRS regulations to be deemed REITs for tax purposes and thereby avoid corporate level taxation. These REIT qualification rules are complex and, among other things, limit the types of assets that may be held by the REIT and the sources of income generated by the REIT and require the REIT to distribute to investors no less than 90% of REIT taxable income to maintain preferential tax treatment.

(b) New DOL Fiduciary Rules and Anticipated SEC Fiduciary Proposals Provide Enhanced Investor Protections from Over-Concentration and Address the Concerns Giving Rise To the Perceived Need for a Concentration Limit.

The release of the final DOL Fiduciary Rule in April 2016 has ushered in a fundamental and profound change in the provision of investment advice to IRAs and certain other qualified retirement plans. This change, which was not contemplated when the Project Group initiated its pursuit of concentration limits, dramatically improves investor protections and addresses the concerns that appear to have motivated NASAA's attempt to fashion such limits. Approximately 40-50% of the typical NL REIT's sales are to IRAs and, as such, will be subject to the DOL Fiduciary Rule.

When the rule takes effect in April 2017, anyone who engages in the following activities for pension plans or IRAs will be deemed an Employee Retirement Income Security Act ("ERISA") fiduciary: (i) provides investment advice for a direct or indirect fee or compensation; (ii) provides advice regarding whether to hold, sell, or purchase any investment in an IRA; (iii) provides any investment management recommendations, including policies, strategies, portfolio composition, etc.; (iv) makes any recommendations regarding IRA rollovers; and (v) makes any recommendation to change the basis of account compensation (*e.g.*, to a higher compensation structure).

An ERISA fiduciary is prohibited from engaging in a wide variety of transactions that might be deemed conflicts of interest. The investment adviser and broker-dealer also are prohibited from receiving variable compensation (*e.g.,* commissions). However, the rule does allow for variable compensation if the transaction qualifies for a prohibited transaction exemption. The rule created a new exemption called the Best Interest Contract ("BIC") exemption ("BIC Exemption"). The BIC Exemption allows for commissions provided the following conditions are met:

- the broker-dealer enters into a written contract with the investor which acknowledges the advisor and the financial institution are acting as fiduciaries;

- the contract states the obligations relating to fiduciary status (*i.e.*, to act in the customer's best interest, to comply with impartial conduct standards including observing a "best interest" rather than "suitability" standard, to receive no more than reasonable compensation and to make no misleading statements);

- the contract must provide for extensive disclosures to the investor including: (i) a statement of best interest standard and how the investor pays fees; (ii) a description of material conflicts of interest, including an explanation of all direct and indirect compensation; (iii) a Notice of Right to obtain additional information (*i.e.* policies, procedures and more specific disclosures of costs); (iv) a link to website disclosure; (v) disclosure of proprietary products and third-party payments; and (vi) a description of any ongoing monitoring of the investment;

- additional specific transaction and internet disclosure to investors and disclosures to the DOL; and

- the imposition of policies and procedures by the broker-dealer and the monitoring thereof to address and reduce potential conflicts of interest in the provision of investment advice.

During discussions with IPA representatives prior to the release of the final rule, DOL officials made clear that front-end weighted commission structures would be deemed inconsistent with policies to reduce potential conflicts of interest. It is clear that the federal regulatory impetus is to move compensation for investment advice toward fee-based compensation and away from transaction-based compensation – a regulatory impetus that clearly discourages over-concentration of investors in high fee products.

The DOL Fiduciary Rule therefore provides enhanced investor protections from over-concentration of investment in NL REITs in the following ways:

- requires recommendations based on the best interests of investors and not simply suitability;

- disallows commission payments for the purchase of NL REITs and other Public Programs in IRA and other retirement accounts unless the investor and the broker-dealer enter into a BIC;

- requires that any commission payments be reasonable in proportion to the service rendered and the standards for other packaged products;

- requires the broker-dealer to institute policies and procedures and compliance protocols to insure that the best interests of investors are not compromised by conflicts of interest; and

- requires full disclosure of all direct and indirect compensation and incentive arrangements with advisors and broker-dealers and recognizes sales incentives (including high fees) and product preferences as conflicts of interest that are disallowed.

Although the DOL Fiduciary Rule applies solely to retirement accounts, the SEC has indicated it will release in Fall of 2016 a fiduciary rule that is anticipated to extend additional protections to all accounts including non-retirement accounts.

iii. <u>Existing State Regulation of Public Programs.</u>

In addition to federal regulations, NL REITs are subject to state-specific regulations. Although regulations may vary from state-to-state, many states apply the REIT Guidelines to their review of NL REITs. The REIT Guidelines address, among other things: the qualifications of the NL

REIT sponsor, external management, and independent directors, the reasonableness of fees and expenses, conflicts of interest, investment restrictions, and disclosures. NL REIT directors and the external management are fiduciaries, and the external management is responsible for the custody and use of all of the NL REIT's funds and investments. In addition, NL REITs have boards comprised of a majority of independent directors. Each of the members of the NL REIT's board of directors must be qualified, having not less than three years of relevant experience demonstrating the knowledge and experience required to successfully manage and acquire the types of assets in which the NL REIT intends to invest, and must meet certain financial requirements. The NL REIT directors are charged with the fiduciary duty of supervising the relationship of the NL REIT with the external management. NL REIT charters establish specific requirements for, and require the approval of at least a majority of the independent directors on, all matters applicable to investment policies, reports and meetings, the contract with the external management and its performance and compensation provisions, fees and expenses, borrowings, and indemnification and other matters. In addition, under the REIT Guidelines, NL REITs are limited as to the indemnification from losses or liability which can be provided to the sponsor or the manager of the NL REIT. The directors, as well as the external management, are deemed fiduciaries to the NL REIT's investors, and that fact is required to be clearly stated in the NL REIT's prospectus.

NL REITs are required to establish minimum investor suitability standards, including income and net worth requirements that are subject to review by the relevant state securities regulators. Along with such suitability, income and net worth standards, the sponsor is required to disclose in the NL REIT's prospectus, among others things: a statement of the NL REIT's investment policy (including the types and geographic locations of planned investments in real estate); a description of its method for financing acquisitions; and information about the properties it owns. The prospectus must also include a breakdown of all fees and expenses, all of which must be reasonable and itemized. Fees and expenses are subject to caps and annual review for reasonableness by the independent directors. The NL REIT must also disclose if it will be leasing or purchasing any assets from the sponsor or the external management. A REIT must provide annual reports, consistent with the reporting requirements of the SEC's Form 10-K, as noted above. Aside from regular reporting and disclosure requirements, the REIT Guidelines also require that an NL REIT's formation document include provisions addressing matters such as restrictions on investments and fiduciary duties of directors and external management, among other provisions.

Unlike many of the products that investors can acquire without concentration limits, approximately 25 states require NL REITs to pass "merit reviews" which involve inquiry and subjective determinations by the state as to the fairness of the offering to investors in that state. Merit state regulators have the authority to deny securities registration and sale in their state if, in the administrator's view, the offering is deemed to be "unfair, unjust or inequitable."

Taken together, NL REITs' regulation under the 1933 Act, the 1934 Act, state securities acts, the REIT Guidelines, state corporation laws, FINRA rules, select provisions of the Internal Revenue Code and Sarbanes-Oxley Act of 2002, and the pending requirements of the DOL Fiduciary Rule make NL REITs a highly transparent and regulated product and more heavily regulated than many, if not most, investments not subject to state-imposed concentration limits.

iv. <u>Investor Protections Through Regulations and Practices Relating to the Distribution of Public Programs.</u>

(a) Regulation of broker-dealers and registered representatives.

NL REITs are distributed through broker-dealers that are registered with the SEC, FINRA and the relevant state securities regulatory authorities. The broker-dealer personnel involved in sales activities ("registered representatives") are also regulated by the SEC, FINRA and the applicable state regulatory authorities. As described below, each participating broker-dealer must conduct due diligence on the offering and an in-depth suitability analysis for all NL REIT offerings. Due diligence investigations for NL REITs are typically conducted by independent third parties, which are highly qualified and experienced in the review of such investments.

(b) Federal and state regulations of NL REIT sales protect investors and require consideration of the investor's individual circumstances and needs.

Broker-dealers are subject to federal and state securities regulations that are designed to protect investors from fraudulent or deceptive sales of securities. [12]

(Note: In addition to the protections discussed in this section, the recent issuance of the DOL Fiduciary Rule and the anticipated release of a fiduciary rule by the SEC are dramatically enhancing investor protections and address the issues underlying the perceived need for a one-size-fits-all-investors concentration limit. See Section 3.D.ii.b.)

Broker-dealers who advise investors with respect to Public Programs are subject to guidelines adopted by NASAA setting forth high standards of honest and ethical conduct of broker-dealers.[13] Such guidelines require, among other things, that broker-dealers: provide investors with a timely disclosure document during the offering period (*e.g.*, a prospectus); charge investors reasonable fees for services provided; and provide written disclosure of any affiliation or common control with the issuer of any security before entering into any transaction. FINRA imposes rules on broker-dealers that require them to conduct due diligence on the products they

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[12] For instance, Rule 10b-5 under the 1934 Act, states in part: "It shall be unlawful for any person . . . (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." *See, e.g.*, Employment of Manipulative and Deceptive Devices, Rule 10b-5 (17 CFR 240.10b-5) under the 1934 Act, available at: https://www.law.cornell.edu/cfr/text/17/240.10b-5.

[13] *See, e.g.*, NASAA Statements of Policy on "Dishonest or Unethical Business Practices of Broker-Dealers and Agents" and supplement "Dishonest or Unethical Business Practices by Broker-Dealers and Agents in Connection with Investment Company Shares," available at: http://www.nasaa.org/wp-content/uploads/2011/07/4-Dishonest_Practices_of_BD_or_Agent.83.pdf and http://www.nasaa.org/wp-content/uploads/2011/07/35-Dishonest_Practices.pdf.

offer, provide full disclosure, provide fair and balanced communications, and assess the suitability of the products they offer when dealing with investors. A broker-dealer's failure to comply with any of the foregoing may result in disciplinary actions, fines, and enforcement referrals to the SEC for each violation.[14]

Federal law and FINRA rules require brokers to "adhere to high standards of conduct in their interactions with investors."[15] As a general matter, the suitability requirements of FINRA Rule 2111 and FINRA Rule 2310(b)(2)[16] mandate that broker-dealers have a reasonable basis to believe that a recommended transaction or investment involving securities is suitable for each customer based on reasonable diligence[17] into the investor's investment profile. Broker-dealers must believe that the customer has the financial ability to meet the commitment of the investment. The suitability obligation requires that broker-dealers make an assessment of: (1) reasonable basis suitability; (2) customer-specific suitability; and (3) quantitative suitability.[18]

Reasonable-basis suitability means that based on reasonable diligence the broker-dealer must have a reasonable basis to believe that the investment product is suitable for some investors. FINRA views the participation of the broker-dealers in a securities transaction as a representation by such broker-dealers that reasonable-basis suitability has been satisfied with respect to that transaction. What constitutes reasonable diligence varies depending on, among other things, the complexity of and risks associated with the security and transaction. Reasonable diligence must provide the broker-dealers (and employees participating in a transaction) with an understanding of the potential risks and rewards associated with the recommended security or transaction.

Customer-specific suitability means the broker-dealers must have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile. Customer-specific information must be obtained and analyzed when making recommendations to customers.

Quantitative suitability means the broker-dealers with actual or de facto control over a customer account must have a reasonable basis for believing that a series of recommended transactions (even if individually suitable) are not excessive or unsuitable in the aggregate in light of the customer's investment profile. FINRA enumerates several factors that might suggest excessive

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14 See, *e.g.*, FINRA Sanctions Guidelines, available at:
http://www.finra.org/sites/industry/Sanctions-Guidelines.pdf.

15 *See, e.g.*, Securities and Exchange Commission, Study on Investment Advisers and Broker–Dealers at 13 (Jan. 2011), available at: http://sec.gov/news/studies/2011/913studyfinal.pdf.

16 *See, e.g.*, FINRA Rule 2111 and FINRA Regulatory Notice 11-02, Know Your Customer and Suitability, available at: http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=9859&print=1

17 For example, broker-dealers have a duty to "to conduct reasonable investigation of securities, including those sold in a Regulation D offering. *See*, *e.g.*, FINRA Regulatory Notice 10-22, Obligations of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings, available at:
http://www.finra.org/industry/notices/10-22.

18 *See, e.g.*, FINRA Rule 2111.

activity, such as turnover rate, cost-equity ratio, and the use of in-and-out trading in a customer's account.[19]

To further protect NL REIT investors, state "blue sky" laws impose their own suitability requirements. Many states model a broker-dealer's responsibility for determining and affirming the suitability of a product after the REIT Guidelines, which include: (1) a product-specific determination as to whether an investor reasonably meets the product-specific net worth and income minimums; (2) evaluating the extent to which an investor would benefit from the product if its investment objectives were met; (3) evaluating the investor's ability to tolerate the product's risks; (4) assessing whether the product's expected liquidity is suitable for the investor; and (5) maintaining records of how reasonable investor suitability was determined. [20]

(c) Broker-dealers offering NL REITs are subject to additional disclosure requirements and investor safeguards.

Broker-dealers offering products, such as NL REITs and other Public Programs, are subject to additional product-specific disclosure requirements pursuant to FINRA Rule 2310. Prior to investing, Section (b)(3) of FINRA Rule 2310 requires "that all material facts are adequately and accurately disclosed [to offerees] and provide a basis for evaluating the program."[21] In determining the adequacy of disclosure, FINRA sets minimum guidelines for broker-dealers, such as requirements for disclosure of: "(i) items of compensation; (ii) physical properties; (iii) tax aspects; (iv) financial stability and experience of the sponsor; (v) the program's conflicts and risk factors; and (vi) appraisals and other pertinent reports."[22] In dealing with conflicts of interest, the SEC takes the position that a broker-dealer's duty of fair dealing falls within the above-mentioned suitability obligation, which generally requires a broker-dealer to make recommendations that are consistent with the interests of its customers. Broker-dealers, when making a recommendation, must disclose material conflicts of interest to their customers."[23] Also, the federal securities laws and FINRA rules restrict broker-dealers from participating in certain transactions that may present particularly acute potential conflicts of interest.[24] Moreover, broker-dealers who fail to adequately disclose conflicts of interest may be subject to the SEC's "remedial sanctions such as censures, suspensions, injunctions and limitations on business, and violators may be required to pay disgorgement and civil penalties."[25]

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19 *See, e.g.*, FINRA Rule 2111, Supplementary Material, Section .05 "Components of Suitability Obligations."

20 NASAA REIT Guidelines, Section III.A-C; NASAA Omnibus Guidelines, Section III.A-C.

21 *See*, *e.g.*, Disclosures for Direct Participation Programs, which includes REITs discussed herein, Section (b)(3)(A) of FINRA Rule 2310, available at:
http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8469.

22 *See*, *e.g.*, Disclosures, Section (b)(3)(B)(i)-(vi) of FINRA Rule 2310.

23 *See*, SEC, Study on Investment Advisers and Broker–Dealers, at 6.

24 *See, e.g.*, FINRA, Conflict of Interest Report (Oct. 2013), available at:
http://www.finra.org/file/conflict-interest-report/.

25 *See*, SEC, Study on Investment Advisers and Broker–Dealers, at 8.

In addition, Section (b)(4) of FINRA Rule 2310 imposes a fair and reasonableness standard upon the organizational and offering expenses, which together with aggregate underwriting compensation may not exceed 15% of the gross proceeds of the offering.[26] In practice, the total combined underwriting compensation and organizational and offering expenses typically do not exceed between 9% and 12% for NL REITs. As previously observed, this limit reflects the aggregate (and highly transparent) charge for advisory services that extend over the five to ten year life of the NL REIT and therefore compare favorably to advisory fees that may be charged over indeterminately long periods, which can and do exceed the percentage typically incurred by NL REITs. As such, NL REITs have an added protection of a lifetime cap, which does not exist in other forms of compensation for other securities which are not subject to any concentration limits. Pursuant to disclosure requirements associated with registration under the 1933 Act, such fee structures are fully disclosed within each product's registration statement.

Moreover, recent amendments to FINRA Rule 2310 and NASD Rule 2340 [27] which became effective in April 2016 impose additional transparency requirements on Public Programs.[28] These rules prohibit broker-dealers from participating in a public offering of NL REITs and other Public Programs unless the issuer has agreed to disclose in its periodic report a per-share estimated value that has been developed in a manner reasonably designed to ensure its reliability.[29] The amended rules also require that customer account statements provide the investment's estimated value, net of up-front fees. In addition, broker-dealers are required to show the methods used for determining the estimated per-share value on a customer account statement, with the use of an independent third-party valuation expert and industry standard valuation methodologies required to obtain accurate valuations after closing of the initial offering.[30] The primary focus of the rules is to increase the transparency of the costs associated with broker-dealer distributed products and improve the "price discovery" and reliability of valuations on customer account statements. These recently required enhanced disclosures are providing more meaningful information to investors, particularly with respect to understanding

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26 *See*, *e.g.*, Organization and Offering Expenses, Section (b)(4) of FINRA Rule 2310 (detailing the fair and reasonableness standards governing organization and offering expenses, compensation, and other fees associated with Public Programs, among others). Note that of this 15% limit, only 10% may constitute underwriting compensation.

27 *See, e.g.*, Customer Account Statements, NASD Rule 2340 (which requires a member to include on customer account statements an estimated value of products, such as the Public Programs, from an annual report, an independent valuation service or any other source), available at: http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=3647.

28 *See, e.g.*, FINRA Rule 2310, amended effective April 2016, available at: http://finra.complinet.com/en/display/display_main.html?rbid=2403&record_id=16009; NASD 2340, amended effective April 2016, available at: http://finra.complinet.com/en/display/display_main.html?rbid=2403&record_id=16008.

29 *See* FINRA Regulatory Notice 15-02, DPP and Unlisted REIT Securities (discussing how amended NASD Rule 2340 will provide two different options for calculating estimated per share values of products, such as the Public Programs, on customer account statements: (a) the net investment methodology ("NIM") which is good for 150 days after the second year following the break of escrow; and (b) the appraised value methodology ("AVM") which must be performed annually). , available at: http://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-02.pdf.

30 *See, e.g.*, FINRA Rule 2310 and NASD Rule 2340.

the cost of brokerage services and the value of their investments, and are beginning to exert downward pressure on distribution costs. For example, during the past 12 months, NL REITs have been introduced which limit distribution costs paid by the REIT to as low as 8.0% and/or provide for sponsor payment of all or a portion of front-end costs. The SEC also imposes disclosure requirements in connection with the offerings of NL REITs, including disclosures with respect to distributions, dilution, redemptions, NAV and prior performance.[31]

In addition to federally required disclosures, many states follow the REIT Guidelines[32] and, as discussed above, require that extensive and specific disclosures be made in product offering documents.

In addition to the foregoing, the IPA has adopted standardized guidelines that address NL REITs. For example, the IPA Practice Guideline on Valuations of Publicly Registered Non-Listed REITs, which incorporated comments and input from FINRA, provides a uniform methodology for valuing NL REITs; guidelines to ensure independence and avoid conflicts of interest in the process of determining valuations; and enhancements of the valuation disclosures for investors.[33] The IPA is presently developing a Guideline for the uniform calculation and reporting of NL REIT investment performance, which is scheduled for release in the first quarter of 2017.

(d) Current standards & practices among broker-dealers relating to assessing suitability and providing investor protections.

In addition to fulfilling regulatory requirements, broker-dealers impose their own internal investor safeguards. Examples include:

- extensive criteria for establishing investor suitability and firm level oversight of implementation of the firm's state suitability standards;
- supervisory procedures to insure adequate determination of investor suitability;
- client-level concentration limits linked to specific client profiles;
- mandatory advisor education requirements related to each specific category of public program asset focus – prior to placing a Public Product with that asset focus with investors.; and

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31 CF Disclosure Guidance, Topic No. 6: Staff Observations Regarding Disclosures of Non-Listed Real Estate Investment Trusts (providing clarification on Rule 4-14 and 3-05 disclosures of broker-dealer placements of public, Non-listed REITs), available at:
https://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic6.htm.

32 *See, e.g.*, NASAA's Omnibus Guidelines, Statement of Policy on Real Estate Investment Trusts, and Statement of Policy Regarding Oil and Gas Programs.

33 *See, e.g.*, IPA Practice Guideline on Valuations of Publicly Registered Non-Listed REITs, available at: http://www.ipa.com/policy-issues/guidelines/.

- on-going FINRA regulatory reviews to confirm the broker-dealer's suitability policy is being consistently implemented.

E. Ongoing Changes in Sales Commission Structures Mitigate Concerns Regarding Incentives Adverse to Investor Interests

Fees charged by broker-dealers relating to the distribution of NL REIT securities have in the past generally been one-time, up-front fees payable out of the NL REIT's gross offering proceeds. These front-end fees include sales commissions, dealer manager fees, and bona fide due diligence expenses, the total of which is limited by FINRA to 10% of the gross offering proceeds. When viewed from the perspective of the underwriting costs associated with initial public offerings ("IPOs") of exchange-traded securities (*e.g.,* in a 2013 study conducted by the Lusk Center for Real Estate at the University of Southern California, total offering and organizational costs for exchanged-traded REITs averaged 8.4% compared with 10.9% for NL REITs)[34] and the fact that these up-front fees in NL REITs are intended to defray the ongoing services of the broker-dealer and its registered representative during the five to ten year life of the investment, these fees compare favorably with the annual fees paid by investors to investment advisers based on assets under management over a comparable multi-year holding period. Independent studies substantiate that annual fees for financial intermediaries who work on an assets under management (AUM) basis and perform services similar to those provided on an ongoing basis during the life of an NL REIT by financial advisors on average ranged between .99% and 1.14% for the years 2011 through 2014 and would total between 4.95% to 7.98% over five to seven years – an amount comparable or exceeding the typical commission consideration received by financial advisors for Public Program investments.

However, NL REITs are undergoing an evolution similar to what transpired throughout the 1980s and 1990s in the mutual fund industry after the widespread adoption of multiple class structures, contingent deferred sales loads (or charges) and other alternative forms of underwriting compensation, which ultimately led to a dramatic decrease in upfront sales charges and trailing commissions.[35] Enabled by rulings by the IRS which permit multi-share class REITs and motivated by the increased transparency of up-front distribution costs which has resulted from recent amendments to FINRA's account statement rules (discussed above), NL REITs are increasingly offering additional share classes with a significantly lower or no up-front distribution cost and trailing distribution and/or shareholder servicing fees that are paid from the earnings of the NL REIT. The table below shows the average sale commissions for various classes of NL REIT shares that are currently on the market.

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[34] Green, Richard K. and Rhea, Parker, "Listed and Non-Listed REIT's: Exploring the Cost Difference," Lusk Center for Real Estate, Marshall School of Business, University of Southern California, Spring 2013.

[35] *See* Mutual Fund Distribution Channels and Distribution Costs, Investment Company Institute Perspective (July 2003); 2015 Investment Company Factbook: A Review of Trends and Activities in the U.S. Investment Company Industry, 55th ed., Investment Company Institute (2015).

Multi-Share Class Products Share Class Characteristics			
Share Class	**Front-End Sales Commission (1)**	**Trail Fees (1)**	**Advisor Type**
A	6.9%	0.00%	Commission
T	2.4%	0.97%	Commission/Fee-Based
R/W	0.0%	0.00%	RIA/Wrap
I	0.0%	0.00%	Institutional

(1) Excludes Dealer Manger Front-End and trail fees and O&O
Source: Robert A. Stanger & Co., Inc.

During 2015 the number of NL REITs registered with a structure offering lower up-front sales commissions and trailing shareholder servicing fees increased over three-fold, from seven to twenty-one (excluding 5 Daily NAV REITs that had been registered prior to this period). Currently, 31 NL REITs registered to offer in excess of $46 billion of securities have low/no front-end and a trailing distribution/shareholder servicing fee structure. Among NL REITs that offer such share classes, the up-front selling commission ranges as low as 2.0% and averages 2.4%, and the total up-front selling commission and dealer manager fees range as low as 4.0% and average 4.86%. Unlike the cumulative fees that can be paid to advisors for recommending many investments that do not have state-imposed concentration limits, NL REITs and other Public Programs are restricted by the aforementioned overall FINRA limitation on total distribution costs as to how long advisors can be paid such trailing fees.

Indeed, no/low load NL REIT share classes already dominate the offering market. Through July 2016, no/low load share classes account for over 63% of all NL REIT 2016 fundraising. Recent trends suggest that many sponsors will offer only no/low load products and will abandon offering the full front-end sales commission products. (See table below.)

Equity Non-Listed REIT Fundraising
Full Commission Vs. No/Low Load/Trail Shares
($ in Millions)

	Full Commission Product		No Low Load/Trail Product					
			Daily NAV		Traditional NL REIT T-Share		Total	
2013	$18,522	98.6%	$233	1.2%	$26	0.1%	$259	1.4%
2014	$14,583	97.3%	$271	1.8%	$140	0.9%	$411	2.7%
2015	$8,975	89.9%	$522	5.2%	$490	4.9%	$1.012	10.1%
2016 thru July	$1,324	47.4%	$505	18.1%	$964	45.5%	$1,469	63.5%

Source: Robert A. Stanger & Co., Inc.

This trend clearly mitigates, if not eliminates, the risk of inappropriate concentration of investor funds in NL REITs motivated by high front-end sales commissions. It is noteworthy that financial advisors selling exchange traded investments have no concentration limits or limits on the number of annual “round trips” (purchases and sales of traded securities) imposed by any regulatory body.

F. The Benefits Provided By NL REITs Are Embraced By A Large and Growing Number of Investors and Financial Advisors

NL REITs can provide a source of income and stability within an investor’s portfolio that is additive to properly constructed portfolios. Millions of Americans hold NL REITs in their accounts. These investments typically offer individual investors access to a variety of real estate asset classes with differing market cycles and correlations. These investments provide current income, growth potential, the potential to hedge inflation, and reduced exposure to the volatility of the traded markets.

The IPA believes NL REITs possess attributes that complement retail and retirement investment objectives and that the existing regulatory structure is sufficiently robust to protect retail investors. In light of the foregoing, restricting the flow of capital through the imposition of a one-size-fits-all-investors, fixed concentration limit would cause more harm than good.

NL REITs have become a common and valued investment for retail investors. As of June 30, 2015, there was over $66 billion of outstanding equity investment in NL REITs. Of these amounts, approximately 44.5% of the non-listed REIT investments were held by IRAs and over 2.8 million retail accounts were invested in NL REITs. Over 31,000 financial advisors currently have placed NL REITs in the portfolios of their clients.

NL REITs invest directly in such real estate asset classes as office, industrial, multi-family residential, retail, healthcare and assisted living, hotel, self-storage and mortgages. Traditionally, these types of investments are intermediate to long-term with a focus on current income, preservation of capital and potential growth. As non-listed, asset-based investments, NL REITs typically have less daily volatility than their exchange-listed counterparts and tend to have a low correlation to other financial asset classes. These features, together with the added diversification that Public Programs bring to financial asset portfolios, can help to enhance an investor’s overall portfolio return while reducing risk. Moreover, Public Programs offer many benefits to investors, including the potential for superior current yields, the potential for competitive total returns, reduced portfolio risk, and access to experienced management teams that specialize in the asset class.

NL REITs clearly serve an important purpose in a taxable retail or tax-exempt retirement portfolio. As many financial advisors have learned, the investment performance of directly owned real estate justifies its inclusion in investor portfolios. The performance of NL REITs also does not correlate directly with the S&P 500, thus providing the type of diversification recommended by Modern Portfolio Theory. Given these attributes and as discussed in more detail herein, there seems to be no principled reason why an IRA investor’s ability to choose how much to invest in NL REITs should be any more restricted than the ability to invest in any other security or investment.

IV. IPA Comments and Policy Concerns with Respect to the Proposed Amendment

A. Comments with Respect to the Text of the Proposed Amendment

The IPA offers the following comments regarding the advisability, practicality and potential unintended consequences of the Proposed Amendment.

i. Basing the Concentration Limit Solely on Liquid Net Worth Rather Than Overall Net Worth Can Exclude Investors for Whom NL REITs Are Clearly Suitable and in Their Best Interest.

The liquidity needs of individuals (even relative to income or net worth) can vary widely. Further, numerous situations exist in which an investor can have ready access to liquidity if needed, but chooses to remain fully invested in non-liquid assets. For example, consider an investor who chooses to deploy his cash and liquid investments to pay off a home mortgage and increase the equity in his home to, say, $750,000 (a sensible course of action under current market conditions where mortgage interest costs significantly exceed the yield available from investment grade fixed income securities, money markets, bank savings accounts and certificates of deposit). This prudent action reduces the investor's liquid net worth and, due to the Proposed Amendment's linkage of the concentration limit to liquid net worth, would eliminate his ability to diversify his portfolio with even a minimal investment in a NL REIT. Yet, this investor would have ready access to liquid capital in the form of home equity loans – which often are made available and linked to credit card accounts.

Another example is an individual business owner. This investor may have access to lines of credit via his business to quickly address any personal liquidity needs. Yet despite having relatively high net worth, this investor would be deprived of the right to invest in NL REITs if a liquid net worth standard is in effect. And a third example would be an investor with little need for liquidity because he or she owns a home, maintains a whole life insurance policy and is seeking current income. Because this investor's net worth is concentrated in illiquid investments (the home and the insurance policy) a relatively small investment in a NL REIT could exceed the 10% concentration limit. The goal of any concentration limit should be to promote diversification across an investor's entire portfolio, not merely that portion which is liquid. By applying the concentration limit to "liquid net worth," the Proposed Amendment does not address diversification of an investor's entire portfolio.

The linkage of the concentration limit to an investor's liquid net worth could also lead to a difficult and highly subjective determination by the broker-dealer at the time of the sale as to which investments are liquid and which are not, and the nature and purpose of any debt held by the investor.

ii. The Text Should Make Clear that the Concentration Limit Assessment Should be Made by the Broker-Dealer at the Time of Sale of Shares in the Primary Public Offering.

The concentration limit should be based on the investor's net worth at the time of sale of shares in the primary offering and should not impose a requirement that the broker-dealer conduct an ongoing assessment of the investor's concentration in the particular NL REIT. An investor's financial situation may change after the time of initial investment, causing the investor's concentration in the NL REIT to exceed the concentration limit. Forcing redemption or sale of all or a portion of the NL REIT securities to bring the holdings back into compliance with the concentration limit is not a tenable solution. Similarly, broker-dealers should not be required to apply the concentration limit with respect to each stock issuance made pursuant to a NL REIT's distribution reinvestment plan. There could be situations where an investor did 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 distribution reinvestment plan, the investor trips the concentration limit. Requiring broker-dealers to monitor the ongoing distribution reinvestments, which happen automatically and generally without involvement of the broker-dealers, would be unduly burdensome and, as noted above, would lead to an ill-advised, forced redemption or sale of the NL REIT securities to reduce the investment to a level that is in compliance with the concentration limit.

iii. Requiring Sponsor Firms to Establish Their Own Concentration Limit that May then be Modified by State Administrators is Not a Workable Approach, Will Lead to Investor Confusion, and Will Make the Process of Capital Formation Much More Complex and Time Consuming for Both Regulators and Issuers.

This requirement will complicate offering reviews, result in multiple rounds of comments thereby increasing regulator and sponsor workloads (and associated costs), inhibit capital formation, and likely result in a multiplicity of un-reconcilable and conflicting concentration limits for a single offering. This outcome will confuse investors and needlessly expose the issuer to potential litigation regarding the reason as to why an investment was appropriate for an investor of one state but not for another. These problems would arise from the differing perceptions of and tolerance for risk among the various Administrators and underscore the fact that concentration limits are most appropriately determined at the investor level based on the characteristics of the individual rather than at the NL REIT level.

The simple fact is that the appropriate process of establishing a concentration limit must be investor-centric and take into consideration the myriad of individual investor variables which can only be evaluated at the advisor-investor level.

It is noteworthy that several of the 14 subjective elements proposed for jurisdictions to review to establish the investment's risk will require the jurisdiction to evaluate events that have not yet occurred (*e.g.,* potential variances in cash distributions, potential shareholders, and potential transactions between the REIT, the sponsor and the advisor). It seems inherently unfair for a state administrator to be able to modify the concentration limit based on speculation.

iv. The Inclusion of "Affiliates" in the Text of the Investments Included in the Concentration Limitation may Result in the Limitation Being Applied to Investments in Asset Classes Other Than NL REITs and Even to Exempt Securities.

The IPA is uncertain of the intent of the reference to Affiliates in Section IV B 1 of the Proposed Amendment which limits a person's aggregate investment in *"the REIT, its Affiliates, and other non-traded REITs."* Further, this provision unfairly and arbitrarily favors sponsors with fewer investment programs over sponsors with a larger number of investment programs. Given the relatively broad definition of an Affiliate in the REIT Guidelines[36] such reference could be interpreted to extend the limitation to the publicly traded securities of a sponsor company, private placements and securities registered under the 1940 Act that are offered by the NL REIT sponsor, or other Public Programs sponsored or advised by the sponsor which do not invest in real estate-related assets (*e.g.,* NL BDCs, or Oil & Gas Programs, Equipment Leasing Programs, or other DPPs). Such other investments represent different underlying asset classes and different streams of income and correlate differently with traditional financial investments, allowing for greater diversification and increased investor protection. In addition, these other investments involve different liquidity capabilities and provisions. In other words, these are different and often non-correlated investments that are additive within a portfolio construction process.

The NL REIT industry is evolving to include much larger institutional-quality sponsors offering more than one NL REIT and multiple other product types. The larger, more experienced sponsors are genuinely believed to offer high quality NL REITs with lower risk than small, less well-capitalized and less experienced sponsors. Including "Affiliates" has the perverse effect of forcing financial advisors to put clients in offerings by unaffiliated, and potentially less high quality, sponsors to avoid exceeding the limits in the Proposed Amendment.

In addition, many of these other investments which sponsors of NL REITs may offer are in types of securities which state securities regulators cannot regulate – for example, private placements, exchange traded securities or funds, and 1940 Act registered, closed-end funds, including interval funds. We respectfully suggest that if NASAA is intent on putting a concentration limit in place, it should at least make clear that it is not attempting to regulate or limit investment in securities which are expressly pre-empted from the purview of state securities laws. A real example of this type of concern arises in the context of private offerings of real estate programs that are intended to qualify as like-kind exchanges under Section 1031 of the Internal Revenue Code ("1031 Exchanges"). Individuals that invest in NL REITs will often also directly own real property. When such individuals sell that real property, it is not unusual for those individuals to want to re-invest the sale proceeds in real estate and defer federal income taxes. This is an investment decision that is completely separate from investing in NL REITs and is in fact dependent on when the real property is sold, since the 1031 Exchanges operate under very tight regulatory deadlines. Multiple sponsors offer private placements that allow such individuals to

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[36] The REIT Guidelines defines affiliate as (i) any Person directly or indirectly controlling, controlled by or under the common control with another Person, (ii) any Person owning or controlling 10% or more of the outstanding voting securities of such other Person, (iii) any officer, director, partner of such Person and (iv) if such other Person is an officer, director or partner, any company for which such Person acts in any capacity.

invest in Delaware Statutory Trusts that are intended to quality as 1031 Exchanges. Under this proposed rule, if such an individual has already met or exceeded the Concentration Limit, that individual could be prohibited from participating in a 1031 Exchange private placement. That outcome, which could result in an adverse effect on that investor that has nothing to do with an investment in NL REITs, should not be what NASAA intends with the Concentration Limit. This is merely one more concrete example of the detriments of a "one size fits all investors" approach.

Lastly, if the inclusion of "Affiliates" is intended or would be applied to include such other investments, then the proposed concentration limit contradicts established principles of effective portfolio risk reduction and increases investor risk by excluding from consideration otherwise appropriate investments which would reduce a portfolio's risk simply because the investment is an "Affiliate" under the REIT Guidelines' broad definition. Academic studies confirm that the major driver of risk reduction in portfolios is not the number of distinct investments held, but rather the holding of assets that have low correlations to one another.[37] For example, increasing the number of assets in a portfolio from 5 to 100 reduces portfolio risk (standard deviation) from 8.94% to 8.67%.[38] In contrast, risk falls to just 4.47% in a portfolio with only five assets when there is no correlation between the assets.

As low correlations among investments dramatically reduce portfolio risk, it follows that an efficiently diversified portfolio should be comprised of assets with disparate characteristics. Yet, depending on the intent and application of the inclusion of "Affiliates" in the definition of the concentration limit, the Proposed Amendment would limit aggregate investment in such diverse investments as domestic and international commercial real estate, oil and gas, alternative energy partnerships, timber, infrastructure, equipment (ranging from transportation equipment to industrial equipment to tech equipment, etc.), research and development, technology, loans to middle market businesses, impact lending, and commodities (which range from agricultural products, to minerals, precious metals and currencies)—activities and assets that have dramatically lower correlations between them than exchange traded equities. In effect, the inclusion of all such Affiliates in a proposed concentration limit, if intended, would reduce the ability of investors to construct portfolios with such disparate asset types, thereby having the unintended consequence of increasing portfolio risk rather than decreasing it, and unfairly favoring sponsors with fewer investment programs over sponsors with a larger number of investment programs. Sponsors with a number of NL REITs can achieve certain economies of scale by allocating certain expenses across multiple NL REITs, which can result in reduced expenses relative to sponsors with only one or two NL REITs. The concentration limit would force investors to invest in sponsors that potentially do not have the economies of scale to result in lower expenses.

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37 Varadi, Kapler, Bee & Rittenhouse study, 2012.

38 Id. Data assumes each asset has a standard deviation of 10% and the average correlation between assets is 0.75.

v. Absence of Demonstrable Data or Analysis by NASAA to Support its Determination of the Percentage Limitation.

The IPA notes that NASAA has, to date, not provided any data or analysis supporting either the conceptual basis of its proposal, the extent of incidences of over-concentration within the NL REIT industry, the financial impact of its proposal on individual investors, capital formation and taxation within the NASAA Members' jurisdictions, or, more specifically, the quantitative metrics that it suggests be imposed. The IPA believes that like federal regulation (which requires among other things, quantitative support and studies by the Office of Management and Budget) state regulations should not be imposed in the absence of a judicious and thorough inquiry into the appropriate provisions of such regulations and their anticipated impact. Without such a rigorous process, the creation of regulatory policy can become relegated to highly subjective and potentially biased and erroneous judgments.

vi. The Requirement in Section IV. B. 5. that Both the Sponsor and the Person Selling Shares Make Every Reasonable Effort to Determine that the Purchase of Shares Meets the Concentration Limit for the Investor.

The responsibility to make every reasonable effort to determine that a purchase of shares meets the concentration limit should be borne by the sponsor or each person selling shares on behalf of the sponsor or NL REIT.

In the selling agreements pursuant to which the offerings of NL REITs are distributed, NL REITs typically delegate the responsibility for determining that an investment is suitable for a particular investor to the broker-dealers that are selling the shares to their retail clients. This is a logical arrangement, given that the broker-dealers have a relationship with their clients and are able to ascertain the information about their clients that is relevant to a suitability determination. NL REITs and their sponsors are not in a position to obtain these private, personal details about the investors, including details concerning the investors' financial situation and investment objectives. An investor rightfully would feel that it was an invasion of his or her privacy if a NL REIT or its sponsor suddenly called or wrote to the investor to request detailed information concerning the investor's overall financial situation, such as the investor's other investments and investment experience. Accordingly, the obligation to determine that a purchase of shares meets the concentration limit should be on the sponsor *or* each person selling shares on behalf of the sponsor or REIT, rather than the sponsor *and* each person selling shares on behalf of the sponsor or REIT.

B. Inadvisability of a One-Size-Fits-All-Investors, Fixed Concentration Limit

The IPA respectfully submits that in proposing a Proposed Amendment that calls for a singular 10% limit on an investor's aggregate investment in all NL REITs and Affiliates, NASAA, while well intentioned, is imposing a standard that does not vary based on the individual investor's personal financial situation, risk-return profile of the portfolio, investment objectives, investment time horizon, desired asset class exposure, and investment profile. Rather, the Proposed Amendment imposes a static, one-size-fits-all-investors standard that fails to consider any of the factors which a financial adviser is required, by SEC, FINRA, and state rules, to consider prior to making an investment recommendation. Because of these existing rules, the IPA believes such a fixed concentration limit is not advisable or necessary for the following reasons.

i. Fiduciary Rules Enacted by the DOL in 2016 and which are Expected to be Proposed by the SEC Prior to Year-End 2016 Provide Significant Additional Safeguards and Remedies and Reduce or Eliminate the Need for a fixed Concentration Limit by the States.

The DOL has issued its final rules imposing a fiduciary duty on financial intermediaries who provide advice to retirement plans. The rules provide for the elimination of variable compensation (*i.e.,* commissions) for any intermediary rendering such advice unless the investor and the provider of the advice enter into a BIC. Although the requirements are complex, in its simplest form such an arrangement would allow a modest level of commission compensation (the so-called BIC Exemption) for certain types of investments. The imposition of a fiduciary standard should address many, if not all, of NASAA's concerns regarding the process of recommending NL REITs to retirement account investors (who account for approximately 44.5% of all investments in NL REITs).

In addition, the SEC has announced that it will introduce its own fiduciary requirement in 2016. This anticipated elaboration of the duties and responsibilities of financial advisors, coupled with the implied increase in liability for dereliction of such duties, also should address the concerns that NASAA seeks to address with its Proposed Amendment.

ii. In Addition to the Investor Protections Provided by the New and Anticipated Fiduciary Rules, Considerable Protections for Investors in NL REITs Already Exist.

(a) FINRA Rule 2111 already limits concentration of NL REIT investments.

FINRA Rule 2111 requires that a firm or associated person "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile." The rule further explains that a "customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation." Given these qualitative factors that the broker-dealer must assess when determining that a particular investment strategy is reasonable for a customer, including factors such as the customer's other investments, risk tolerance and liquidity needs, the likelihood of over-concentration in a manner that is not suitable for the customer is greatly diminished.

(b) Broker-Dealers already impose concentration limits on individual investments in NL REITs.

The IPA understands that each investor's goals, financial situation and risk tolerance should be considered before investing and that NL REITs are not suitable for every investor. That said, the IPA believes that the financial advisor is best positioned to determine his or her client's suitability for an investment through direct conversation with that client. Advisors determine whether and how much of any particular investment is right for a client. This determination varies from client to client.

Furthermore, the oversight responsibility at the broker-dealer level extends to the proper implementation of alternative investments. This is typically accomplished through concentration limits as well as in-depth suitability reviews.[39] This determination is not made by a simple percentage calculation, nor should it be, given the responsibility imposed on financial advisors.

(c) The IPA believes existing state requirements provide effective and sufficient protections for investors.

A described above, unlike traded securities, most Public Programs are not only subject to SEC registration and review, and distribution oversight by FINRA, but are also subject to individual state-by-state reviews. Approximately 25 of these states require merit reviews. State regulators hold the authority to deny securities registration if the offering is deemed "unfair, unjust or inequitable."

State requirements include, among other things, the satisfaction of income and minimum net worth standards, and investors must receive receipt of the prospectus five days before a purchase is effective. Each of these items is further vetted by compliance personnel at their respective broker-dealer firms. In contrast, investments in traded securities settle three days after the trade, in some cases without the investor having time to review the final prospectus.

iii. Establishing Suitability for an Individual Investor is a Dynamic and Complex Process which is not Amenable to a Static, One-Variable Test.

Establishing suitability and the concomitant financial capacity of an investor to commit a given level of funds to Public Program investments requires consideration of a wide variety of investor variables, including age, preferred investment strategy and objectives (*e.g.,* aggressive growth, moderate growth, growth and income, income), current and anticipated tax situation, risk tolerance, investment experience, portfolio composition and diversification/concentration preferences, composition of personal balance sheet, current and future income and anticipated expenses, among others.

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[39] It is noteworthy that a debate persists among investment professionals as to the relative merits of concentrated investing versus broad diversification following Modern Portfolio Theory. Concentrated investing practitioners (such as Warren Buffett, George Soros, Bill Ackman, Martin Whitman and even John Maynard Keynes) have recognized the role of concentrated investing in above-average wealth building. At least one study has shown that concentrated investing can increase portfolio return while reducing portfolio risk. Yeung et. Al. 2012 study cited by Lazard Asset Management.

The totality of these multi-faceted and dynamic considerations cannot be encapsulated in a static, one-variable test (*i.e.,* percentage of net worth or liquid net worth that can be invested in a particular type of investment).

iv. <u>The Creation of Regulations that Restrict the Economic Choices of Individuals and Impede the Efficient Flow of Capital Should be Undertaken Only When Preceded and Supported by Rigorous Research and Data Gathering.</u>

The need for regulations that restrict or abolish the public's freedom of choice and impede the efficient competition for capital should be supported by demonstrable research and fact-based information. Establishing a one-size-fits-all-investors concentration limit (or even a flexible limit) should be based on quantitative analysis supporting the circumstances justifying such a limit, the magnitude of the limit, and the anticipated economic benefit and implicit costs of imposing such a limit. Such economic analysis and justification is required at the federal level, yet appears to be lacking in NASAA's establishment of a proposed 10% limit and to what such limit applies. The IPA has previously offered to participate in a joint task force to assist NASAA in assessing the need, economic costs and benefits of a Concentration Limit in a process consistent with the rigorous qualitative and quantitative analysis applied by other government agencies. The IPA reiterates its willingness to do so here.

v. <u>The Low Level of Over-Concentration Instances in the NL REIT Industry and the Successful Resolution of Such Rare Instances of Negative Behavior Should Significantly Temper The Perceived Need for Regulatory Restriction of Individual Choice.</u>

The regulatory trade-off between individual choice and freedom versus providing investor protection should be guided at least in part by the prevalence of the negative behavior being addressed and the investor's recourse with respect to such negative behavior. The IPA is not aware of any substantial data gathering and analysis that has been performed by NASAA to establish the extent of over-concentration practices in the industry or the resolution of those instances of negative behavior achieved through arbitration, litigation or regulatory enforcement.

The IPA believes that the lack of such data calls into question the propriety of instituting regulatory restrictions on individual choice.

vi. <u>Overly Restrictive Regulation Runs the Risk of the Unintended Consequence of Investors Embracing Products with Less Oversight and Greater, Rather than Less, Risk.</u>

Current federal and state regulatory regimes provide significantly more investor protections with respect to investments in Public Programs (which are all publicly registered, SEC-reporting entities) in comparison to investments in private placement securities. Significantly limiting the ability of an investor, guided by his or her professional advisor, to invest in NL REITs can have the unintended consequence of driving such investors to significantly less transparent, less regulated and therefore more risky private placements or internet crowd funding investments.

vii. Investments in NL REITs have a Significant Positive Economic Impact Nationwide and within NASAA Member Jurisdictions in terms of Employment, Income and Tax Revenues.

The capital formation in the NL REIT sector over the past 10 years has produced significant commercial real estate investment across the country, and in NASAA member states specifically. These investments support thousands of jobs in construction, health care facilities, apartment buildings, shopping centers, office buildings and hotels. (See Section III.A.vii above for an example of the economic impact of NL REITs in the jurisdictions of the Project Group members.)

viii. There are No Suitable Replacements for NL REIT Products, or the Value They Provide, Available to the Retail Investment Community.

NL REITs provide value to investors in terms of diversification, low correlation with exchange traded equities and fixed income investments, and stable income. Whereas high-net-worth and institutional investors have the financial resources to make direct investments in commercial real estate and to access other alternatives to diversify their portfolios (see Section III.C.vi above regarding the composition of U.S. College and University Endowment Portfolios), average retail investors must rely on pooled investment vehicles. Yet, the only way for such investors to obtain these benefits within the context of a highly-regulated and transparent, public-reporting vehicle, is to invest in NL REITs. Overly severe limitations that restrict investors from accessing NL REITs would have two unintended consequences:

- exposing individual investors to unnecessary market risk; and
- motivating individual investors to invest in higher risk substitutes such as private placements, crowd funding and liquid alternatives.

V. IPA Recommendation and Proposal For Amendment of the REIT Guidelines

The following summarizes the IPA's position and recommendations regarding the Proposed Amendment to the REIT Guidelines.

A. Concentration Limit Provisions

Although the IPA and its members believe consideration of the percentage of an investor's net worth in a particular asset class is one appropriate consideration among several relevant factors for determinations of suitability, such determinations should be based on facts and circumstances specific to each individual investor. These factors go beyond net worth and income and may include such customer-specific considerations as risk tolerance, investment experience and sophistication, investment time-frame, nature of wealth holdings (both liquid and illiquid), family situation and outlook, financial and lifestyle objectives, etc. Further, as cited herein, when placing NL REITs, broker-dealers typically evaluate factors beyond net worth and income when considering the appropriate product concentrations for an individual investor. Therefore, the IPA believes that a one-size-fits-all-investors concentration limit as proposed is neither necessary nor in the best interests of investors. The IPA also believes that the goal of any concentration limit should be diversification across investors' entire portfolios, as opposed to merely their liquid portfolios. For this reason, among others cited herein, any concentration limit should be based on total net worth (excepting homes, home furnishings and automobiles) and not liquid net worth.

If NASAA still wishes to proceed with an amendment to the REIT Guidelines reflecting the imposition of a concentration limit, then the IPA recommends that it delay such consideration until after the positive impact of the DOL Fiduciary Rule can be assessed and after the SEC proposes its fiduciary rules.

If NASAA nevertheless intends to proceed now to amend the REIT Guidelines to include a concentration limit, the IPA believes the following provisions should form the standard:

- The basis of the concentration limit is investor net worth (exclusive of home, home furnishing and automobiles) at the time of the investment in primary shares. The concentration limit should not be applied with respect to stock issuances pursuant to the NL REIT's distribution reinvestment plan.

- The concentration limit is applied solely to the investment in an individual NL REIT (exclusive of investments made via a distribution reinvestment plan) and not to all NL REIT investments and investments in Affiliates.

- Section IV.B.5. of the Proposed Amendment should be revised to indicate that the sponsor *or* each person selling shares on behalf of the sponsor or REIT is obligated to determine that a purchase of shares meets the concentration limit for each shareholder, rather than the sponsor *and* each person selling shares on behalf of the sponsor or REIT. This is consistent with the two sentences in Section IV.B.4., which use "or" rather than "and."

- In lieu of concentration limits, the suitability portion of the REIT Guidelines should be amended to take into account access to a prudent amount of cash or liquid investments to cover unexpected emergencies.

- The concentration limit should not be applied to persons deemed accredited investors under the income or net worth standard of Rule 501 of Regulation D.

B. Process of Defining Concentration Limits

If NASAA intends to amend the REIT Guidelines to include a concentration limit, only one concentration limit should apply to an investment in each NL REIT, and NASAA should not facilitate the modification of the uniform limit by permitting administrators to review various factors in order to establish a higher limit. Similarly, the amendment to the REIT Guidelines should make clear that the accredited investor exception applies to an investment in each NL REIT and is not subject to the various state administrators' determination to allow the exception.

C. Required Recordkeeping and Disclosures

The IPA supports NASAA's proposal that the prospectus should include disclosure that clarifies that application of the concentration limit to a particular sale of shares does not obviate the requirement to comply with other existing rules and requirements concerning the suitability of the investment. However, the language of Section IV.A.3 of the Proposed Amendment could lead to confusion if added to a prospectus exactly as currently written. For example, it is not clear to which rules NASAA is implicating with the reference to "existing administrative rules." In the past, when the REIT Guidelines have included a requirement that particular disclosure be included in the prospectus, certain state administrators have required the language to be included in the prospectus verbatim, without any variance that may be required based on particular circumstances to clarify the language. Accordingly, the first sentence of Section IV.A.3 of the Proposed Amendments should be revised to read:

> "Any PERSON selling SHARES on behalf of the SPONSOR or REIT shall adhere to the concentration limit disclosed in the PROSPECTUS. In addition to compliance with the concentration limit requirement, any PERSON selling SHARES on behalf of the SPONSOR or REIT must also satisfy the suitability determination required under Section III.C. of this Statement of Policy and the rules of any self-regulatory organization concerning the sale of SHARES."

VI. CONCLUSION

NL REITs effectively address the needs of retail investors and also contribute to the overall U.S. economy and to the employment, economies, and tax revenues of the various NASAA jurisdictions. The benefits of NL REITs parallel the benefits of many alternative investments available only to institutional and high net worth investors. NL REITs have been shown to perform well, enhance portfolio diversification, and improve the risk-adjusted return potential of an investment portfolio by adding a product in an asset class that does not correlate with the traded stock market. These benefits are of significant value to retail investors. The controls and requirements imposed upon those who distribute the NL REITs and on the products themselves (*e.g.,* FINRA rules and existing REIT Guidelines requirements as to the suitability, expense limitations, related party transactions, disclosure, investor qualifications and suitability, maximum investment amounts, and merit state reviews) provide even higher standards than the regulatory standards placed on most other investment products that are not subject to any concentration limitations, many of which entail significantly more potential volatility and risk of capital loss than NL REITs. Most importantly, the recently enacted DOL Fiduciary Rule and the anticipated fiduciary rule to be issued by the SEC provide dramatically expanded investor protections and effectively eliminate the need for the imposition of a one-size-fits-all-investors, fixed concentration limit and the corresponding regulatory imposition of limitations on the ability of investors and their financial advisors to create the most appropriate investment portfolio.

For all the reasons set forth above, the IPA urges NASAA to seriously consider the industry recommendations contained herein at Section V. Further, the IPA renews its offer to form a joint task force to address issues related to the amendment of the REIT Guidelines and future undertakings to improve the quality of investment products and advance the interests of individual investors.

Respectfully submitted,

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Gerald Rome, Treasurer
Diana Foley, Secretary
Kevin Anselm, Director
Joseph Borg, Director
Kelly Gorman, Director
John Morgan, Director

Appendix A

Overview of Publicly Registered, Non-Listed Real Estate Investment Trusts

NL REITs are investment vehicles, typically in the form of a trust or corporation that directly invest primarily in real estate and/or real estate-related loans. Equity NL REITs own, manage, and lease income-producing commercial real estate in nearly all property sectors, including office, industrial, apartment, retail, health care, self-storage, data center, and hotel. Mortgage NL REITs provide debt financing to the owners of commercial real estate. NL REITs are subject to the same federal tax requirements that an exchange-listed REIT must meet, including requirements relating to the composition of their investment portfolios and the requirement that they distribute at least 90% of taxable income to shareholders annually.

Investors in NL REITs generally receive regular cash distributions, typically over a five to ten-year holding period. In addition to providing current income, NL REITs can provide growth of capital through appreciation of their real estate investments, which growth is realized upon the provision of full liquidity to investors through either listing of the NL REIT on a national securities exchange, merger, or sale of the assets. Individual retail and retirement investors purchase shares of NL REITs to implement the same strategy used by institutional investors to diversify financial asset portfolios, because NL REITs have historically exhibited low correlation with public equity markets. NL REITs can also provide a hedge against inflation and rising interest rates superior to that of most fixed income investments that do not provide for any potential appreciation of the capital invested or the opportunity for increases in regular cash distributions. Moreover, NL REITs have shown a lower correlation to public equity markets than listed REITs, so NL REITs provide superior diversification against market swings.