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Andrea Seidt, Section Chair
Mark Heuerman, Project Group Chair
North American Securities Administrators Association
750 First Street NE, Suite 1140
Washington, DC 20002

RE: Proposed Revisions to NASAA Statement on Policy Regarding Real Estate Investment Trusts

Dear Ms. Seidt and Mr. Heuerman:

We welcome the opportunity to comment on the proposed revisions (the "Proposal") to the North American Securities Administrators Association ("NASAA") Statement on Policy Regarding Real Estate Investment Trusts (the "NASAA REIT Guidelines"). Simpson Thacher & Bartlett LLP has significant experience representing sponsors and issuers of investment products, including non-traded real estate investment trusts ("non-traded REITs") and non-traded business development companies ("non-traded BDCs"). We submit the following comments on our own behalf and the views contained herein do not necessarily reflect the views of any of our clients.

Overview

We frequently assist sponsors in developing investment products that are offered to ordinary Americans, sometimes referred to as "retail investors," including advising during the initial concept stage, negotiating with investors and intermediaries, and ultimately, launching the product. We wish to note that we strongly agree with NASAA's vision to "protect investors from fraud and abuse, educate investors, support responsible capital formation, and help ensure the integrity and efficiency of financial markets."[1] However, aspects of the concentration limit set forth in the Proposal, as drafted, exceed the legal authority vested in states to regulate U.S. securities offerings. In addition, we believe the proposed concentration limit will arbitrarily limit retail investors from accessing investment opportunities that can diversify their portfolios, and may result in more sponsors seeking alternative structures that are not subject to state regulation in order to make their products available to retail investors

[1] *Welcome to NASAA – NASAA Vision*, available at https://www.nasaa.org/about/.

that seek diversification. We do not believe that this type of “regulatory arbitrage” serves the interests of retail investors.

For the reasons set forth below, we encourage NASAA to consider removing, or in the alternative, modifying, the restrictions in the Proposal – especially, the concentration limit.

Concerns Related to the Proposed Concentration Limit

The Proposal requires a sponsor to establish a concentration limit, subject to approval of each state administrator. However, the Proposal, if adopted, also would impose a default concentration limit that a person’s aggregate investment in the applicable non-traded REIT, its affiliates and other non-traded direct participation programs may not exceed 10% of the investor’s liquid net worth. For the reasons set forth below, we respectfully submit that the concentration limit should be removed or modified.

1. Prescriptive Concentration Limits Are Inconsistent with Recent Regulation Regarding the Practices of Intermediaries.

We respectfully submit that any prescriptive concentration limit would be inappropriate.

Today, NAV REITs, i.e., those non-traded REITs that continuously offer and redeem at a price computed at the net asset value (“NAV”) based on the values of the underlying properties they own, are largely distributed through the nation’s largest broker-dealers and investment advisers.[2] These broker-dealers and investment advisers and their financial professionals are subject to Regulation Best Interest (“Reg BI”), recently promulgated by the Securities and Exchange Commission (“SEC”), or a fiduciary standard, respectively, and, if adopted, would also be subject to the new conduct standards in the Proposal.

As briefly noted in the Proposal, Reg BI imposes an enhanced standard of care, disclosure and conflict of interest obligations on broker-dealers and their associated persons. A broker-dealer and its associated persons must act in the “best interest” of retail customers when making any recommendation of any securities transaction or investment strategy, without putting the financial or other interests of the broker-dealer (or its associated persons) ahead of the retail customer. To form a reasonable basis that a product would be suitable for a retail customer, broker-dealers must consider important factors such as the security’s or investment strategy’s

[2] In the Proposal, NASAA appears to unduly focus on lifecycle REITs, which currently make up less than 1% of non-traded REIT sales, as the bellwether for the non-traded REIT industry. NAV REITs have received more acceptance from investors because they offer significantly better terms to investors compared to legacy lifecycle REITs, including better liquidity, NAV-based pricing rather than arbitrary pricing, lower distribution and servicing fees and more transparent management fees. In addition, many lifecycle REITs had sponsors that specialized in only lifecycle REITs and were distributed exclusively through smaller intermediaries while most NAV REITs have sponsors that are highly regarded in the broader institutional and retail investor space and are distributed through sophisticated multinational intermediaries.

investment objective, characteristics (including any special or unusual features), liquidity, volatility and likely performance in a variety of market and economic conditions.[3] Furthermore, broker-dealers and their associated persons must consider a variety of factors specific to each retail customer when making a recommendation of a specific product, including, but not limited to, the retail 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 retail customer may disclose to the broker-dealer and/or the associated person.[4]

Similarly, the fiduciary standard under the Advisers Act of 1940, as amended (the "Advisers Act"), imposes a duty of care and a duty of loyalty, which requires the investment adviser to, at all times, serve the best interests of its clients and not subordinate a client's interests to its own.[5] The duty of care requires, among other things, that the investment adviser not place its own interest ahead of its client's interests. A client's interest is understood based on a reasonable understanding of the client's investor profile. Accordingly, an adviser must make a reasonable inquiry into the client's financial situation, level of financial sophistication, investment experience and financial goals. To fulfill its duty of loyalty, an adviser must (i) make full and fair disclosure to its clients of all material facts relating to the advisory relationship and of all conflicts of interest that might incline an adviser – consciously or unconsciously – to render advice that is not disinterested and (ii) obtain a client's informed consent to such facts and conflicts. This combination of loyalty and care obligations has been characterized as requiring an investment adviser to act in its client's best interest at all times.[6]

Reg BI and the Advisers Act's fiduciary standard impose strict obligations on broker-dealers and investment advisers recommending securities to retail customers. These obligations require that financial professionals consider an individual client's circumstances rather than apply a "one size fits all" approach and therefore provide better protection for retail investors. Among other things, these obligations require broker-dealers and investment advisers to tailor securities recommendations to each retail investor consistent with their individual profile and specific circumstances. Further, these obligations require investment advisers and broker-dealers to adopt and implement policies and procedures reasonably designed to prevent violations by the broker-dealer or investment adviser (and their associated persons) of Reg BI or the Advisers Act's fiduciary standard, as applicable. Such policies and procedures are subject to rigorous review through SEC and Financial Industry Regulatory Authority, Inc. ("FINRA") examination. These policies and procedures also require training to ensure financial professionals have the structure and guidance to understand how to form an adequate

[3] *See Regulation Best Interest: The Broker-Dealer Standard of Conduct*, Exchange Act Release No. 34-86031; File No. S7-07-18 [84 FR 33669] (June 5, 2019) at 262.

[4] *See Id.* at 273.

[5] *See Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Advisers Act Release No. 5248; File No. S7-07-18 [84 FR 33669] (June 5, 2019) at 2.

[6] *See Id.* at 13.

basis to make recommendations to, and investments for, retail customers that are consistent with customer investment objectives and risk profiles. On an individual-level, certain investment adviser representatives and all registered representatives (of broker-dealers) are required to demonstrate their qualification by sitting for series examinations, or other professional licenses.

Because broker-dealers and investment advisers are required to understand the customer investment profile and characteristics of any investment recommendation, broker-dealers and investment advisers are in the best position to determine the appropriate level of exposure for each individual client. The Proposal's implication that a single concentration limit is appropriate for all investors, regardless of an investor's circumstances, is flawed and runs contrary to the fundamental principles of Reg BI and the Advisers Act. In other words, the Proposal would interfere with the relationship between retail investors and their chosen financial professionals to the detriment of the retail investor. Further still, breaches of duties under Reg BI or the Advisers Act on the part of a broker-dealer or investment adviser are subject to regulatory review, scrutiny and enforcement. In effect, the Proposal would set aside the considered judgment of the SEC regarding the relationship of a financial intermediary with his or her client, and substitute NASAA's judgment for that of the SEC (regarding the relationship between an intermediary and his or her client), individual financial professionals and the ordinary Americans they serve.

The Proposal provides the theoretical opportunity to allow for a higher concentration limit when appropriate, however, such discretion would ultimately be in the discretion of the state administrator rather than the investor's financial professional.[7] A state administrator is not in a position to make an informed decision about what level of investment is in the best interests of an individual retail investor because the state administrator necessarily does not have insight into, and does not consider, the investor's individual financial circumstances and goals. The investor's financial professional by nature of his or her role and statutory obligations is required to obtain the information related to, and has the responsibility to consider, an investor's individual circumstances. Further, an investor also chooses his or her financial professional and thus elects a certain investment style; a decision that is significantly personal and not taken lightly for most retail investors. Accordingly, the investor's financial

[7] Importantly, even if a state administrator determined that a particular non-traded REIT merited a higher concentration limit, this would have limited practical effect because the Proposal applies the concentration limit to all non-traded direct participation programs. For example, if an investor invested 6% of his/her liquid net worth in "Non-Traded REIT A" for which the applicable state administrator allowed a 20% concentration limit, the investor would still be prohibited from investing an additional 6% in "Non-Traded REIT B" if "Non-Traded REIT B" were subject to the default 10% concentration limit. The fact that "Non-Traded REIT A" was permitted a higher concentration limit by such state makes no difference in what amount the investor is permitted to invest into "Non-Traded REIT B." This also illustrates that the state administrator would not have knowledge of what investments are in the investor's portfolio, whereas the investor's financial professional would, and is therefore better suited to make investment recommendations.

professional is better suited to determine any concentration limits that should apply to that individual investor.

Ultimately, we have serious doubts that a systematic substitution of judgment by state administrators in place of the judgment of the individuals the Proposal purports to protect is a wise policy decision. We have significantly greater doubts that it is appropriate for the several states to regulate an area with this level of prescription when the SEC only recently promulgated standards applicable throughout the nation designed to regulate the same investment recommendations.[8] At a minimum, the states should observe how effective the federal regulation of this type of recommendation is before rushing to override the federal standards.

2. If Any Concentration Limit is Applied, then:

   a. Affiliates Should be Removed from the Concentration Limit.

Should NASAA adopt a concentration limit, we strongly recommend that "affiliates" are removed from any adopted concentration limit.

As noted above, the Proposal would apply a concentration limit to a person's aggregate investment in the non-traded REIT, its affiliates and other non-traded direct participation programs. The Proposal defines "affiliate" to include, among other things, any person that (a) directly or indirectly owns, controls, or holds, with power to vote 10 percent or more of the

[8] The Proposal notes that NASAA believes Reg BI has not brought about sufficient change in brokerage practices. This appears to be based in part on the fact that brokerage clients continue to invest in non-traded REITs, but the fact that investors are investing in NAV REITs (which as noted above offer significant advantages over lifecycle REITs) does not mean that Reg BI is not effective. While Reg BI may be imperfect, we contend that many, if not most, firms have updated their policies and procedures to include an enhanced standard of conduct and now also provide enhanced disclosures. Reg BI allows for a principle-based application rather than a rule-based application, more in line with the Advisers Act fiduciary standard that we believe will ultimately provide better protection over time. In any case, the Proposal's effect of supplanting the judgment of financial professionals (including investment advisers that are subject to a fiduciary standard) with the judgment of a state securities administrator is not an improvement.

NASAA also notes that REITs have been subject to significant FINRA complaints and that Reg BI has not reduced complaints. However, these FINRA statistics, notably, do not set forth the date of the alleged conduct (i.e., whether the conduct occurred pre- or post- Reg BI effectiveness) as arbitration cases may be filed up to six years after the alleged conduct, do not provide the nature of the complaint or the outcome for such cases (i.e., whether complaints related to REITs resulted in a finding of wrongdoing on the part of the investment professional) and do not delineate what type of REIT the complaint related to (i.e., whether the complaint related to a listed REIT, lifecycle REIT or a NAV REIT).

outstanding voting securities of another person; or (b) directly or indirectly controls, is controlled by, or is under common control with another person.

Importantly, because many NAV REITs are sponsored by the nation's largest asset managers, this broad definition could encompass federally-registered investment companies, publicly listed securities, securities issued in federally exempt offerings (including pursuant to safe harbor rules under Section 4(a)(2) of the Securities Act of 1933, as amended (the "Securities Act"), such as Regulation D) and other "covered securities." However, pursuant to the National Securities Markets Improvement Act of 1996 ("NSMIA"), states are preempted from directly or indirectly regulating such offerings.[9] By limiting how an investor can purchase covered securities alongside securities of non-traded REITs, it is our considered legal view that this provision would place an indirect limitation on the offering of covered securities and thus violate Section 18 of the Securities Act.[10] If the intent of the Proposal is to cover only affiliates that are themselves non-traded direct participation programs that are not covered securities, then the reference to affiliates can be removed without changing the meaning of the Proposal because the current Proposal covers all non-traded direct participation programs (whether affiliated or not).

b. The Concentration Limit Should not Include other Non-Traded Direct Participation Programs.

Should NASAA adopt a concentration limit, we strongly recommend that "other non-traded direct participation programs" be removed from the concentration limit.

As previously noted, the Proposal would limit a person's investment in other direct participation programs. The Proposal does not define "direct participation programs," and, as proposed, this term could be read to include "covered securities" which, as noted above, are preempted from regulation by the states under NSMIA. If NASAA does not remove "direct

[9] *See* Section 18 of the Securities Act and Section 203A of the Advisers Act, as amended by NSMIA. Section 18 of Securities Act provides "[e]xcept as otherwise provided in this section, no law, rule, regulation, or order, or other administrative action of any State or any political subdivision thereof, (1) requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply to a security that (A) is a covered security; or (B) will be a covered security upon completion of the transaction; . . . . ; or (3) shall directly or indirectly prohibit, limit, or impose conditions, based on the merits of such offering or issuer, upon the offer or sale of any security described in paragraph (1)."

[10] For example, under the Proposal, if an investor sought to invest 6% of his/her liquid net worth in a registered investment company and an additional 6% of his/her liquid net worth in a non-traded REIT with the same sponsor, the investor would be restricted from making both investments in tandem, without adjusting his or her investment decision. The effect of the concentration limit would, therefore, indirectly limit the investor's ability to invest in securities of the registered investment company, a covered security.

participation programs," we recommend that NASAA provide a definition of "direct participation programs" and clarify that this limit would not include covered securities.[11]

In addition, these investment products have varying business models as compared to non-traded REITs. For example, a non-traded REIT focused on real property has dramatically different investment exposures from a non-traded BDC that invests primarily in corporate credit. By putting these two very different investment strategies under the same low concentration limit, NASAA would be detrimentally limiting an investor's ability to diversify his or her portfolio, and again, substituting the judgment of state administrators for the judgment of individual financial professionals and their clients.

NASAA primarily cites the liquidity risks inherent in these direct participation programs as a reason to impose a concentration limit. While NAV REITs provide enhanced liquidity compared to lifecycle REITs,[12] we acknowledge that NAV REIT securities have more limited liquidity compared to listed securities.[13] While it is always prudent for an investor to have sufficient liquidity, a rational investor may seek to have a portion of his or her portfolio in investments that are less liquid (particularly when holding investments for the longer term) if such investments historically have less volatility and/or offer different return profiles (including lower correlation to the broader listed securities markets). How much of an investor's investment portfolio should be in less liquid investments is a decision best left to

[11] We are aware that New Jersey, which is the only state we have seen apply a concentration limit that is similar in breadth to that of the Proposal, has applied a concentration limit that applies to direct investment programs and has included language showing examples of such programs and clarifying that such limitation excludes unregistered, federally and state exempt private offerings.

[12] Before 2016, the non-traded REIT industry was predominately lifecycle REITs. These lifecycle REITs were designed as finite-life vehicles with a life of 5 to 9 years at which time they would seek a liquidity event. Redemptions were limited to up to 5% of the weighted average number of shares outstanding during the prior 12-month period and often reflected either arbitrary or penalizing valuations to discourage redemption request except for hardship situations. In contrast, NAV REITs have an enhanced opportunity for liquidity through regular redemptions at NAV per share at a time chosen by investors subject to certain limitations.

[13] We note, however, that NASAA does not acknowledge that listed securities are historically more volatile than non-traded securities. In the Proposal, NASAA points out that a handful of NAV REITs did not offer or fully satisfy redemption requests during the initial moths of the recent COVID-19 pandemic. In contrast, investors in listed REITs would have been able to liquidate their investment. However, we note that the typical listed REIT lost nearly 30% of its market value in the first quarter of 2020. Thus, while any listed REIT investor could have achieved liquidity during this time period, they could have only done so by realizing a dramatic loss compared to where their investment started the year. Presumably, a NAV REIT investor could have sold their interest on the secondary market at such a discount as well.

the investor and his or her financial professional who, unlike a state regulator, are aware of the investor's financial circumstances and goals.

NASAA notes, in particular, that less liquid investments may be less appropriate for elderly investors.[14] We do not disagree that many elderly investors will have more need for short term liquidity than younger investors. However, the Proposal makes no differentiation by age; investors whether young or old and regardless of circumstances would be subject to the same proposed 10% limit. Further, under existing NASAA REIT guidelines persons selling non-traded REIT securities must already consider the investor's age in determining whether the investment is suitable for the investor. As previously noted, Reg BI and the Advisers Act also require that an investor's age be considered when recommending an investment product or securities strategy.

c. NASAA Should Include an Exemption for Accredited Investors.

Should NASAA adopt a concentration limit, we strongly recommend an exemption for accredited investors, as defined in Regulation D under the Securities Act, or alternatively another standard. We respectfully note that, in its 2016 proposed revisions to the NASAA REIT Guidelines, NASAA proposed a similar concentration limit but would have included an exemption for investors that meet the definition of an "accredited investor" as defined in Regulation D under the Securities Act, and therefore, our recommendation is not without precedent.

The SEC has stated that its accredited investor definition is "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investments or fend for themselves render the protections of the Securities Act's registration process unnecessary."[15] The Proposal notes that NASAA does not recommend an accredited investor exemption from the concentration limit because the SEC has not made inflationary adjustments to the definition. However, on June 22, 2022, the SEC announced plans to review, and potentially adjust, the accredited investor standards,[16] and we urge NASAA to hold off on adopting any concentration limit until the SEC releases further guidance. But even if

[14] In the Proposal, NASAA states non-traded REITs are "heavily marketed" to elderly investors, perhaps suggesting that elderly investors (more than other investors) are a target for non-traded REITs. However, NASAA does not provide any data substantiating this suggestion other than anecdotal advice for elderly investors to consider the risks of these products.

[15] *See Regulation D Revisions; Exemption for Certain Employee Benefit Plans*, Securities Act Release No. 33-6683 [52 FR 3015] (Jan. 16, 1987).

[16] *See* SEC, *Regulation D and Form D Improvements*, RIN 3235-AN04 (Spring 2022), available at https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202204&RIN=3235-AN04 ("The Division is considering recommending that the [SEC] propose amendments to Regulation D, including updates to the accredited investor definition, and Form D to improve protections for investors.").

NASAA is unsatisfied with a lack of inflationary adjustment, it does not follow that the only solution is to have no exclusion to the concentration limit. For example, NASAA could propose an exclusion for investors that meet an accredited investor standard with inflationary adjustments determined by NASAA or use a different standard, such as one that looks to the wealth prong of the accredited investor definition only and not the income prong. The Proposal, if adopted, would apply to all investors, even investors that meet the definition of "qualified purchaser" as defined under Section 2(a)(51) of the Investment Company Act of 1940, as amended (the "Investment Company Act"), who are permitted to invest in private funds. It would be an illogical result that an individual qualified purchaser could invest in private funds (which are not subject to state regulation) without limit but would be restricted from investing in non-traded REITs. Sophisticated investors are capable of making their own investment decisions and wealthier investors, simply by virtue of having greater overall resources, are able to tolerate a greater percentage of limited liquidity in their portfolio than are less wealthy investors.

Further, the Proposal specifically states that many elderly investors would qualify as accredited investors because of accumulated retirement savings, implying that all elderly investors lack the sophistication to make their own investment decisions. We do not think it is appropriate to assume that investors have less sophistication simply by virtue of their being elderly.

Moreover, it is logical to exclude accredited investors from any concentration limit since these accredited investors would also be eligible to invest without limit in private securities offerings that are not subject to state regulation. Indeed, a non-traded REIT that is identical in all respects to one offered to retail investors can be limited to accredited investors and sold privately. Such private REITs have less transparency, less oversight by both the SEC and states, and are not subject to the investor protections included in the NASAA REIT Guidelines (e.g., independent director requirements and related transactions subject to independent director approval, among other things). This is precisely the type of regulatory arbitrage that the states should want to avoid.

d. The Concentration Limit Should Apply only to Non-Traded REITs that do not Provide Liquidity At Least on a Quarterly Basis.

Should NASAA adopt a concentration limit, we strongly recommend that such limitation only apply to non-traded REITs and other public direct participation programs that do not provide liquidity based on NAV at least on a quarterly basis.

NAV REITs, unlike legacy lifecycle REITs, provide routine liquidity to investors through monthly repurchase programs that are subject to certain limitations. Many states have required NAV REITs to revise their share repurchase plans to remove language related to the ability of the board of directors to terminate the repurchase program. However, the Proposal cites the suspension of some repurchase programs during the beginning of the recent COVID-19 pandemic as evidence of liquidity risks in non-traded REITs and as justification for a concentration limit. However, NASAA cites only three NAV REITs that suspended their repurchase programs during the COVID-19 pandemic. Further, the investment strategy of one of the cited NAV REITs focuses on the mortgage sector, which was greatly impacted (and disproportionally compared to equity focused REITs) by the COVID-19 pandemic[17] (e.g., the typical listed mortgaged REIT lost 54% of its market value in the first quarter of 2020), and notably, other mortgage non-traded REITs did not suspend their share repurchase programs. Indeed, the lesson from the market dislocation caused in March 2020 and the following months by the onset of the COVID-19 pandemic should be that NAV REITs are resilient and less volatile than listed REITs, and therefore, should be exempt from any adopted concentration limit.[18]

3. The Concentration Limit may have Unintended Consequences and Diminish Investor Protections.

Should NASAA adopt a concentration limit, we respectfully submit that such concentration limit may lead to unintended consequences and diminish investor protections.

In response to a stricter concentration limit, many sponsors and distributors may consider alternative avenues to raise capital, which may be outside of the purview of state regulators. For example, sponsors and distributors may increase private offerings pursuant to Regulation D under the Securities Act, register as an investment company under the Investment Company Act or pursue other structures that are not subject to state review. Accordingly, NASAA's objectives to increase investor protections through the Proposal would likely inspire market participants to instead reach investors through products that are not regulated by the states at all.

Conclusion

We appreciate the opportunity to submit, and NASAA's consideration of, our comments to the Proposal. Should NASAA have any questions regarding these comments, please feel free to contact Rajib Chanda at 1-202-636-5543 or rajib.chanda@stblaw.com, Benjamin Wells at

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[17] See Ronamil Portes, *About 50% of US mortgage REITs cut, suspend dividends over COVID-19 crisis,* S&P Global (Apr. 29, 2020), available at https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/about-50-of-us-mortgage-reits-cut-suspend-dividends-over-covid-19-crisis-58192321 ("Since March [2020], share prices of mortgage REITs have plummeted due to uncertainties surrounding the industry's ability to meet rising margin calls, forcing them to focus on maximizing and preserving liquidity.").

[18] *See NAV REITs Post Year-to-Date 2020 Gains and Far Superior Performance to Listed REITs Over the Last 36 Months Despite Real Estate Struggles Due to COVID-19,* Robert A. Stanger & Co., Inc., Press Release (Nov. 2, 2020), available at https://irei.com/wp-content/uploads/2021/01/Press-Release-11-2-2020-IPA-Stanger-Monitor-.pdf; *NAV REITs Continue to Outperform Their Traded Counterparts as Impact of COVID-19 Appears in the Review Mirror*, Robert A. Stanger & Co., Inc., Press Release (Apr. 28, 2021), available at https://irei.com/wp-content/uploads/2021/04/Press-Release-4-28-2021-IPA-Stanger-Monitor.pdf.

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Sincerely,

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