IPA
Institute for Portfolio Alternatives

March 29, 2021

Representative Jean Schmidt
House District 65
77 South High Street
12th Floor
Columbus, Ohio 43215

**Re: Response to Division of Securities Letter**

Dear Representative Schmidt:

The IPA[1] appreciates the opportunity to respond to a March 8th letter[2] from the Division of Securities concerning its regulation of non-listed[3] real estate investment trusts ("REITs") and non-listed business development companies ("BDCs"). The Division's letter, which reflects its bias against these heavily-regulated investments, is filled with distortions and mischaracterizations. Even more important, it exposes the Division's evasion of the Joint Committee on Agency Rule Review (JCARR) when it conducts unauthorized rulemaking.

***Overview***

The Division dedicates the first seven pages of its letter to an argument about which there is no dispute, that publicly-offered, non-listed REITs/BDCs should be regulated. While these seven pages are rife with factual inaccuracies, the IPA agrees wholeheartedly that offerings of REITs/BDCs should be regulated. Indeed, *they are.* For example:

- REITs/BDCs must register their public offerings with the SEC under the Securities Act of 1933. Like other public companies, REITs/BDCs must disclose the terms of their offerings and material information about the issuer in their registration statements and prospectuses, file them with the SEC

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1 For over 30 years, the Institute for Portfolio Alternatives ("IPA") has raised awareness of portfolio diversifying investment ("PDI") products among stakeholders and market participants, including investment professionals, policymakers, and the investing public. The IPA regularly provides substantive input to regulators such as the U.S. Securities and Exchange Commission ("SEC") and the Financial Industry Regulatory Authority ("FINRA"), and it has developed best practice guidelines to standardize industry practice, enhance transparency and performance, and provide consistent metrics. Furthermore, the IPA is committed to ensuring that all investors have access to real assets and the opportunity to diversify their investment portfolios with PDI products, based on appropriate standards of financial and personal suitability and consistent with the investment goals of the investors.

2 Letter from Commissioner Andera L. Seidt, Division of Securities, to Representative Jean Schmidt (March 8, 2021) (the "Division Letter").

3 We refer to the products discussed herein as "non-listed" rather than "non-traded" because although their shares are not listed on a national securities exchange nor registered with the SEC, they are freely tradable. As a result, "non-listed" is a more accurate description, one widely adopted by industry participants.

(along with sales material that will be used in the offering) and deliver the prospectuses to investors. These prospectuses must be amended, filed and delivered to investors as material developments occur. Non-listed REITs/ BDCs also must register their public offerings in every state where their securities are offered and sold.

The Division complains that REIT/BDC prospectuses "are dense and utilize technical industry jargon."[4] The Division surely knows that this exhaustive disclosure, with its "jargon," is a product of the thorough regulation of these prospectuses by the SEC and the states.

- REITs/BDCs must file annual and quarterly public reports and real-time, current reports on material developments under the Securities Exchange Act of 1934. Thus, like other public companies, REITs/BDCs must file annual audited financial statements on Form 10-K, quarterly financial statements on Form 10-Q, and material development disclosures on Form 8-K.
- The SEC regulates BDCs in a manner similar to investment companies, pursuant to many provisions of the Investment Company Act of 1940.
- REITs/BDCs are sold through broker-dealers that are regulated by FINRA and the SEC, and investments advisers that are regulated by the SEC and the states. FINRA regulates the marketing of REITs/BDCs by broker-dealers and the compensation that they receive in the distribution of REITs/BDCs.
- REITs/BDCs must have an independent board of directors with a fiduciary responsibility to ensure that the REIT/BDC is operated and managed in a manner consistent with the stockholders' interests.

The question is not whether securities offerings by REITs/BDCs should be regulated. They are extensively regulated. The question is why, in registering them, the Securities Division exceeds its authority granted by the Ohio legislature. The IPA recently submitted a letter in response to the 5-year Ohio Division of Securities Rule Review discussing this overreach of authority.[5]

Some of the largest and most reputable asset management firms create and distribute REITs/BDCs. The largest sponsor of non-listed REITs and BDCs today is the Blackstone Group, which is also the largest private equity firm with over $619 billion of assets under management.[6] Other large institutional managers include Jones Lang LaSalle, Starwood Capital Group, TIAA Nuveen, Hines and Owl Rock. Some of the largest broker-dealers in the United States, including large wirehouses such as Morgan Stanley, UBS and Bank of America Merrill Lynch as well as independent broker-dealers including Ameriprise and LPL and other financial intermediaries, distribute REITs/BDCs. Notably, even OPERS, Ohio's largest public pension fund, had approximately $9 billion in non-traded real estate investments and commitments and

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[4] Division Letter at p.2.

[5] Letter from IPA to Ohio Securities Division and Common Sense Initiative on Ohio Division of Securities Rule Review (March 21, 2021), available at https://www.ipa.com/wp-content/uploads/2021/03/IPA-Letter-Ohio-Division-of-Securities-Rule-Review-3.21.21.pdf.

[6] *See* https://www.investopedia.com/articles/markets/011116/worlds-top-10-private-equity-firms-apo-bx.asp#citation-2.


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$16 billion in non-traded private equity/credit investments and commitments in 2019.[7] The report also notes a 22% target allocation in real estate and private equity/credit for 2019.[8]

We make two essential points. First, in regulating REITs/BDCs, the Division regularly exceeds its statutory authority and evades the JCARR. Second, the Division does so because it has an irrational bias against REITs/BDCs, one grounded in a misunderstanding of their purpose, structure, and recent investment history.

## 1) <u>The Securities Division Exceeds its Statutory Authority</u>

Most publicly-offered securities are registered in Ohio and other states in one of two ways. If the offering is *not* registered under federal law, such as when the offering is exempt from federal registration, the offering may be registered in the state "by qualification." If the offering is federally registered, then it is state-registered "by coordination."

### a) *The Division Deliberately Applies the Wrong Registration Standard*

Securities offered by REITs/BDCs are registered by coordination in the State of Ohio.[9] As the term "coordination" implies, the Division is supposed to coordinate its review and effectiveness with the U.S. Securities and Exchange Commission, which has primary authority to dictate what information must be included in the registration statement and prospectus and its conditions for effectiveness.

Offerings by REITs/BDCs are *not* registered by qualification. This registration method is reserved for offerings that are not registered by the SEC and thus deserve greater scrutiny by the Division. As the SEC has said, registration by qualification "requires a full review of the transaction by the state."[10]

The Division deliberately applies the wrong registration standard to REITs/BDCs. In its letter the Division admits to its illegitimate application of conditions reserved in Ohio law for registration by qualification. Referring to Section 1707.09, the Division asserts:

> That standard [for registration by coordination] requires a Division finding that "the business of the issuer is not fraudulently conducted, that the proposed offer or disposal of securities is not on grossly unfair terms, that the plan of issuance and sale of the securities

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7 2019 OPERS Comprehensive Annual Financial Report, at 66, available at https://www.opers.org/pubs-archive/financial/cafr/2019-OPERS-Comprehensive-Annual-Financial-Report-CAFR.pdf.

8 OPERS, at 71.

9 Ohio Revised Code Section 1707.091.

10 Report on the Uniformity of State Regulatory Requirements for Offerings of Securities That Are Not "Covered Securities" (October 11, 1997), https://www.sec.gov/news/studies/uniformy.htm.


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> referred to in the proposed offer or disposal would not defraud or deceive, or tend to defraud or deceive, purchasers."[11]

The Division thus admits that it exceeds its statutory authority, for Section 1707.09 and the quoted standard apply to registration *by qualification*, not the simpler registration by coordination to which REITs/BDCs are subject. A different provision, Section 1707.091, applies to registration by coordination. Under this provision, a REIT/BDC's registration statement becomes effective:

> either at the moment the federal registration statement becomes effective or at the time the offering may otherwise be commenced in accordance with the rules, regulations, or orders of the Securities and Exchange Commission.

The filer must meet a few simple conditions for this automatic effectiveness: a stop order or similar proceeding may not be in effect, the registration statement and certain statements concerning the offering must be on file with the Division for a requisite number of days, and the filer must pay the registration fee.

The Division represented to you that the requirements for registration by qualification are "applicable" to registration by coordination.[12] As its letter says,

> In reviewing the registration applications of securities offerings, the Division is bound by the standard set forth in Revised Code Section 1707.09(G), which is rooted in the Division's longstanding anti-fraud authority.[13]

This statement is incorrect. There is nothing in the Ohio Revised Code that applies the registration-by-qualification provisions of Section 1707.09 to the registration by coordination provisions of Section 1707.091. The Division's only authority to apply qualification standards for a registration by coordination is to issue a formal stop order proceeding.[14] This authority does not extend to the review of applications to register an offering by coordination.

The Division's enforcement of an inapplicable statutory provision, its imposition of a standard only relevant to a formal stop order proceeding in Section 1707.091, and its denial of registration by coordination to REITs/BDCs, constitute a clear violation of the Ohio Revised Code.

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[11] Division Letter at p. 8.

[12] Division Letter at n. 24.

[13] Division letter at p. 8.

[14] Ohio Revised Code Section 1707.091(C)(1); Ohio Administrative Code 1301:6-3-09.1.


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*b) The Division Applies Standards that Have Nothing to Do with Registration*

One must distinguish between REITs/BDCs and the broker-dealers that distribute REIT/BDC securities. A REIT/BDC and the broker-dealer that distributes its securities typically are separate, unaffiliated entities with disparate businesses and different regulatory responsibilities.

The Division's letter expresses concern about how regulated broker-dealers and other intermediaries will distribute the securities of REITs/BDCs. Many of the state actions listed in Attachment A of the Division's Letter concern the behavior of third parties who sell REITs/BDCs, not the REITs/BDCs themselves. The Division asserts that REITs/BDCs are sold to investors "who did need cash (and could not get it)," that they may be "mismatched with an investor" in "unscrupulous sales," that broker-dealers who sell them have been the subject of investor complaints.[15] These wildly exaggerated, unsupportable generalizations about how these well-regulated investments are sold by regulated financial intermediaries, are irrelevant to the registration by coordination of REIT/BDC offerings under Ohio law. In other words, these opinions have nothing to do with the structure of a REIT/BDC, its disclosure of the terms by which it will operate, or the effectiveness of its SEC registration. In short, they have nothing to do with the criteria by which the Division must grant registration by coordination.

The Division asserts that the federal Regulation Best Interest standard, which applies only to broker-dealers and not to REITs/BDCs or their sponsors, will make these products more of a "sticky wicket."[16] This comment is also untrue; as noted above, REITs/BDCs are broadly distributed, including by some of the largest broker-dealers, and are offered by large institutional asset managers. Broker-dealers have also put into place extensive policies and procedures to govern distribution of products in all asset classes, and multiple share classes for non-listed products help align those products with Regulation Best Interest.

The Division illicitly conditions REIT/BDC securities offering registration according to how they might hypothetically be sold by third parties over whom the REIT/BDC sponsor has little control. At least one IPA member thus received this astonishing comment from the Division concerning the SEC's Regulation Best Interest, which applies to selling broker-dealers, not the REITs/BDCs themselves:

> Your offering circular currently has a suitability section. The Division asserts that the issuer should include appropriate Regulation Best Interest disclosures into this section or in close proximity to this section as a standalone section. Please include in this disclosure the following:
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> i. Regulation Best Interest adoption date;
>
> ii. Regulation Best Interest may be interpreted as a higher standard than suitability;

[15] Division Letter at p. 7, pp. 10-11.

[16] Division Letter at p. 2.


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iii. The basic requirements of Regulation Best Interest that include the general obligation and four component parts;

iv. That no administrative or case law exists under Regulation Best Interest and the full scope of its applicability is uncertain; and

v. the relationship between the prospectus and Form CRS previously provided to the prospective purchaser.

Please disclose in the suitability section that any or all of the quantitative standards listed in the suitability standard may be more restrictive pursuant to Regulation Best Interest.

This comment introduces a whole new requirement, one not even made by the agency that *promulgated* Regulation Best Interest, the U.S. Securities and Exchange Commission.

The Division says that it "counts on broker-dealers to fulfill their gatekeeping function and appropriately match these investment products with the right investors."[17] The IPA supports this approach by the Division because it recognizes that broker-dealers, not the REITs/BDCs themselves, are responsible for matching these products with the right investors. The Division therefore should not impose conditions for broker-dealers on the offering of REIT/BDC securities. It would be especially inappropriate for the Division to impose conditions that conflict with Regulation Best Interest, which is the product of the SEC's multi-year development of a standard of care for broker-dealers.

*c) <u>The Division Evades the JCARR</u>*

The Division's letter reveals that in its review of REIT/BDC registration it evades the JCARR. As the Division says, "the JCARR rulemaking-process has no role or application" in its review of these filings.[18]

The Division asserts that it "does not promulgate rules in a merit review of a registration filing."[19] This is simply false, because the Division engages in merit review through informal rulemaking without the formal process required under Ohio law. This merit review allows the Division to exercise its own judgement on the merit or worthiness of an offering before allowing its registration in Ohio.[20] By contrast, the federal securities regulator (the U.S Securities and Exchange Commission) applies only a "disclosure-based"

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[17] Division Letter at p. 9.

[18] Division Letter at p. 13.

[19] Division Letter at p. 13.

[20] The Division relies on the following "registration-by-qualification" authority on all corporate finance filings to approve or disapprove of an offering: "the business of the issuer is not fraudulently conducted, that the proposed offer or disposal of securities is not on grossly unfair terms, that the plan of issuance and sale of the securities referred to in the proposed offer or disposal would not defraud or deceive, or tend to defraud or deceive, purchasers."


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regime when reviewing securities filings of issuers and intermediaries. This approach means only that material disclosures are required to provide investors with the information necessary to make their own informed investment decisions.

The Division's policies, pronouncements and determinations under the guise of "merit review" are not subject to legislative review or the JCARR process. The Division asserts this authority by (i) making new and inconsistent substantive comments on filings that are supposed to be registered by coordination, (ii) issuing Ohio Securities "Bulletins" that announce to the public new pronouncements and legal requirements, all of which are applied by the Division without formal rulemaking; and (iii) automatically applying "statements of policy" issued by the trade association of state securities commissioners, the North American Securities Administrators Association (NASAA).[21] The states most active in developing those statements of policy include Ohio, New Jersey, Massachusetts, Maryland and Washington.[22] As cited on the Division's website under "Existing Guidelines, Merit Standards for Securities Filings,"[23] the Division applies those merit review standards "in the exercise of its discretion" on a case-by-case basis.

The Division's letter itself refers to several examples of this extraordinary misuse of agency power. For example, in the first quarter 2020 Ohio Securities Bulletin[24] the Division stated that it will not permit the inclusion of data from the NCREIF Property Index (the "NPI") and other indices because they "tend to deceive investors."[25] In its letter the Division calls the NPI "an advertising tool developed by the industry" and warned that retail investors "are not sophisticated and may not appropriately understand how these indexes work."[26]

The NPI, however, is widely-used to analyze the performance of commercial real estate and is used as a benchmark for actively managed real estate portfolios. The State Teachers Retirement System of Ohio, for example, educates Ohio teachers about the investments in their pension portfolio by reference to the NPI and other indices.[27] The Division's disallowance constituted a new rule promulgated beyond the scope of the JCARR. Although the Division's concerns about the index are misplaced, it should air those concerns

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[21] Division Letter at pp. 8, 17.

[22] States representative on the NASAA Corporation Finance Section include Vermont, Massachusetts, Washington, Ohio, New York, Pennsylvania. A Project Group of the Corporation Finance Section, the Direct Participation Programs Policy (which includes REITs/BDCs), includes Ohio (as Chair), Pennsylvania, New Mexico, New Jersey, Maryland, Massachusetts and Washington.

[23] *See* https://www.com.ohio.gov/secu/ExistingGuidelines.aspx. These statements of policy include Blank-Check Preferred Policy; Blind Pool And Blank Check Offerings Prohibited; Cheap Stock Policy Statement; Debt Service; Dilution Policy Statement; Future Transactions With Affiliates; General Standards On Debt-To-Equity Ratio; Insider Loan Policy; Insolvent Issuer Policy; Misleading Issuer Names; Options And Warrants; Organizational And Offering Expense Policy; Selling Security Holders; Subordinate Voting Rights Policy; Underwriter Compensation Policy; Use Of Proceeds; and Varying Terms.

[24] Ohio Securities Bulletin – Issue 2020:1.

[25] Ohio Securities Bulletin -- Issue 2020:1.

[26] Division letter at p. 13.

[27] *See* https://www.strsoh.org/_pdfs/investments/assets-report.pdf


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publicly, with an opportunity for comment by the industry, investors and consumer groups, before denying filers the opportunity to use the index for investor education.

The Division also evades the JCARR through its comment process. For example, the Division recently objected to the ability of REITs/BDCs to use offering proceeds to fund distributions, citing this practice as "grossly unfair"– a standard for registration by qualification but not REIT/BDC registration by coordination.

Both federal and state law permit REITs/BDCs to make appropriate use of offering proceeds as well as other sources of capital for distribution, and the Division had no authority to prevent this practice. The IPA objected to this attempted rulemaking-through-comment, pointing out that the Division's requirement that distributions not be funded from offering proceeds "is tantamount to a new law, both in Ohio and federally" and "[t]he Division does not have the authority to unilaterally impose new legal requirements on its issuer registrants merely through the objection in its review process of legally allowable actions."[28]

Following the submission of the IPA's letter, the Division agreed to temporarily withdraw its comment regarding distributions in lieu of further case law or regulatory interpretation of Regulation Best Interest (a federal regulation that, coincidentally, should have nothing to do with REIT/BDC issuers' registration filing in Ohio or, for that matter, the internal governance of any securities issuer). The Division instead stated that it will require "enhanced disclosure in the prospectus [that regulatory agencies have not passed upon new broker-dealer conduct standards]." It is unclear what the practices of third-party broker-dealers who distribute REITs/BDCs have to do with registration of REIT/BDC securities. Moreover, the Division has complained about the length of the REIT/BDC prospectus; this is a great example of why the prospectuses have become so long.

When the Division makes comments such as these, and when the issuer is unable to convince the Division that the comment is inappropriate, the issuer typically will be compelled to comply rather than withdraw the filing and entirely avoid offering its securities in Ohio. The Division boasts that over the last 8 years, "The Division has reviewed over 600 non-traded REIT and non-traded listed BDC filings and has cleared 95% of them."[29] We question this number, and it would be interesting to explore how it was derived. At any rate, the question is not how many filings the Division approved. The question is how many rules the Division imposed on those offerings that were not authorized by the Ohio Revised Code or the JCARR.

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[28] Letter from IPA to Commissioner Andrea L. Seidt, Division of Securities (January 19, 2021). The IPA listed 9 discrete legal reasons that the Division's actions were not justified or legally allowable, including: "[m]ost non-listed REITs are Maryland corporations, and this practice is permissible under Maryland law if approved by the board of directors. Further, Ohio's proposed requirement would not just impact Ohio residents, but all investors, regardless of where they reside, as REITs cannot declare a separate distribution for holders of a particular class of securities that reside in Ohio. This restriction would impact the REIT's ability to declare and pay distributions to residents of all jurisdictions."

[29] Division Letter at p. 8.


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These comments concerning the NPI and the payment of distributions are but a few examples among others in which the Division exceeds its statutory authority and evades the JCARR rulemaking process. We would be happy to discuss other, similar examples.

## 2. The Division has an Irrational Bias Against REITs/BDCs

The Division's Letter illustrates its irrational bias against REITs/BDCs, which partly emanates from its lack of interest in how these products have evolved. In order to understand these programs, one must appreciate the fact that they are designed to provide retail investors with access to relatively illiquid investments that are normally reserved for wealthy institutions *and* provide these retail investors with liquidity and transparency about the net asset value (NAV) of the portfolio and its fees and structure.

In short, REITS/BDCs give retail investors the opportunity to diversify their investment portfolio for their financial prosperity. Institutional investors, such as pensions and endowments, have invested in real estate and private credit for decades, benefiting from an income stream and portfolio diversification. As noted earlier, some of the most well-respected asset management companies, broker-dealers and investment advisers offer and distribute REITs/BDCs to their retail customers, and Ohio's largest public pension fund, OPERS, allocates investments to non-listed illiquid real estate and private equity/credit investments.

The Division's letter ignores two important points about REITs/BDCs. First, they invest in illiquid assets and must be structured and managed accordingly. The form of the fee paid to the external advisor, including any performance feature, the offering of sustainable redemption rights, and the valuation methodologies, are consistent with the nature of the underlying investments. The well-respected asset management companies who sponsor REITs/BDCs have developed sophisticated operations to match redemption rights, transparency, and investor protections with less liquid underlying portfolios.

Second, the Division confuses the earlier generation of these investments, often referred to as "lifecycle" programs, with the "NAV" programs that are mostly sold today. In fact, for the year-to-date as of December 31, 2020, of the approximately $10.8 billion raised in non-listed REITs, about 99% was raised for NAV REITs.[30] The differences between a lifecycle and NAV program are vast. Lifecycle REITS/BDCs are limited-life products that liquidate at the end of their term. They generally provide their first appraisal of assets well after investors have purchased them. NAV REITs/BDCs are perpetual-life products that are structured similarly to mutual funds that continue to raise capital indefinitely. NAV REITs generally provide updated NAV on a daily or monthly basis and provide their stockholders the ability to request redemption of their shares in an aggregate amount of up to 2% of NAV per month, not to exceed 5% of NAV per quarter and 20% of aggregate NAV per year—an approximately *four-fold* increase from the amount of liquidity previously offered by lifecycle REITs. Similarly, NAV BDCs provide their shareholders the ability to request redemption of their shares in an aggregate amount of up to 5% of common shares outstanding per quarter, and in some cases, up to 5% of aggregate NAV. The IPA sent a

[30] Source: Stanger Market Pulse.


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detailed description of these industry changes in a letter to the Division after publication of its first quarter 2020 Bulletin, which took a similarly and unfairly biased tone toward the industry.[31]

One interesting feature of the Division's letter is its preference for publicly-listed REITs/BDCs. For example, the letter cites two flawed studies that rely on data concerning publicly-listed REITs/BDCs or that were produced by the sponsor of a publicly-listed REIT.[32] Publicly-listed REITs/BDCs may have their benefits, but they also have their disadvantages in comparison to non-listed REITs/BDCs. In particular, because they attempt to provide a liquid security wrapped around a relatively illiquid portfolio, the price of their shares will not always reflect the value of the underlying assets and they will tend to experience market volatility when non-listed REITs/BDCs do not. Similarly, publicly-listed REITs are not required to provide third party valuations of the underlying real estate so the stock price may widely diverge from the actual value of the real estate.

Recent events during the height of the pandemic have highlighted the volatility of publicly-listed REIT performance as measured by the MSCI US REIT Index. The index fell by 44.0% between its 2020 high on February 21st and its low on March 23rd. The weekly swings during this time period were as high as 25.5% and averaged 11.8%.[33] The first quarter 2020 Bulletin also asserted that "non-traded REITs may underperform their listed counterparts, i.e., traded REITs listed on national exchanges,"[34] but the article omitted the fact that non-listed REITs can also outperform listed REITs. For example, for the three-year periods ending December 31, 2018 and December 31, 2020, NAV REITs outperformed publicly-listed REITs (while for the three-year period ending on December 31, 2019, publicly-listed REITs outperformed NAV REITs).[35]

In comparison to traded REITs, NAV REITs, which are the predominant product in the space and make up an overwhelming majority of current non-listed REIT sales, overall performed well, met redemptions, paid distributions, and acted to preserve long term shareholder value and repositioned themselves for a Covid

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[31] Letter from Neal Sullivan, Sidley Austin LLP, on behalf of the IPA, to Andrea Seidt, Commissioner, Ohio Division of Securities, *available at* https://www.ipa.com/wp-content/uploads/2020/07/2020.05.22-Response-Ltr-to-OSD-Investor-Bulletin.pdf (May 22, 2020).

[32] Division Letter at n.10 (citing study by Cohen & Steers); Division Letter n. 41 (citing flawed study by Craig McCann, who has been discredited by federal courts). Further, contrary to the Division's position, the SEC did not rely on the McCann study in its Regulation Best Interest adopting release as it was merely a footnote of an economic analysis discussion. The SEC's rule is product agnostic and does not address specific product types.

[33] *See* MSCI US REIT Index ("RMZ") Performance January 1, 2020 to April 14, 2020.

[34] Ohio Division of Securities, *Private Indexes in Advertising and Non-Traded REIT Valuations,* OHIO SECURITIES BULL., 2020:1, at 4.

[35] *See* Robert A. Stanger & Co., Inc., *Tracking the Performance of Alternative Real Estate Investments*, The IPA / Stanger Monitor, Vol 1(1), at 2 (Winter 2019), available at https://www.ipa.com/wp-content/uploads/2019/01/IPA-STANGER-MONITOR-WINTER-2019.pdf; *see also* Robert A. Stanger & Co., Inc., *Tracking the Performance of Alternative Real Estate Investments*, The IPA / Stanger Monitor, Vol 2(1), at 2 (Winter 2020), available at https://www.ipa.com/wp-content/uploads/2020/02/IPA-STANGER-MONITOR-WINTER-2020.pdf; *see also* Robert A. Stanger & Co., Inc., *Tracking the Performance of Alternative Real Estate Investments*, The IPA / Stanger Monitor, Vol 3(1), at 2 (Winter 2021), available at https://www.ipa.com/wp-content/uploads/2021/01/IPA-STANGER-MONITOR-WINTER-2021.pdf.


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and post-Covid world. Traditional lifecycle REITs functioned as designed, reducing distributions, limiting redemptions, and working to preserve the functionality and financial health of their portfolios for their respective future liquidity events. As the pandemic began to normalize into a new normal, lifecycle REITs have begun to reactivate redemptions and distributions levels, consistent with the performance of the underlying real estate assets.

The Division's letter makes a host of mischaracterizations, all of which the IPA would be happy to dispel at any time. For purposes of this letter, we will discuss three separate mischaracterizations concerning distributions, liquidity, and fees.

A. The "Distribution" Myth

Many regulated broker-dealers and investment advisers recommend an allocation to public, non-listed REITs/BDCs to their clients, as an essential element of a diversified investment portfolio, primarily due to the regular income these investments can provide in the form of distributions, as well as their potential for modest capital appreciation. REITs/BDCs intend to pay distributions from cash flow from operations, but may also pay distributions from other sources, such as debt and the sale of assets. When necessary, such as early in the life of a program when the capital raise is in its nascent stage and the assets that will constitute the initial investment portfolio are being acquired, the program may pay distributions from offering proceeds, which may reflect a return of capital for tax purposes. NAV REITs in particular have a disincentive to pay distributions from sources other than cash flow from operations, since doing so will result in a reduction in their NAV. The SEC requires investment programs to identify the source of distributions in the programs' periodic reports filed with the SEC, such that investors will be notified if distributions are paid from sources other than cash flow from operations. The payment of regular distributions is a primary investment objective of most non-listed REITs/BDCs, as is the case with respect to many other companies, including listed REITs/BDCs and companies that offer bonds, other fixed income investments, preferred stock, and common stock.

The Division refers to the maintenance of distributions from offering proceeds as a "Ponzi scheme."[36] We are uncertain of what conclusion should be drawn from the fact that the Division has an affinity for publicly-listed REITs/BDCs, which it does not regulate, but calls non-listed REITs/BDCs, *which it does regulate,* "Ponzi schemes." A Ponzi scheme is a fraud in which perpetrator promises unrealistically high returns to be generated from a scheme that turns out to be ephemeral. The legal return of capital to an investor does not constitute a fraud. We hope that the Division is aware that a REIT/BDC registered under the Securities Act and state law, with an independent board of directors and that is required to file audited financial statements and periodic and current reports with the SEC, is regulated under the Investment Company Act (in the case of a BDC), and has actual investment operations and engages in real asset management for its shareholders – is not a Ponzi scheme. Unfortunately, the Division wants to cast aspersion on this already heavily regulated industry, for which it has demonstrated significant antipathy through its publications and actions.

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[36] Division Letter at p. 2.


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## B. The "Liquidity" Myth

REITs/BDCs invest in relatively illiquid assets such as real estate, mortgages, and small business loans. Because the underlying assets are relatively illiquid, limited liquidity of the REIT/BDC security is appropriate. REIT/BDC securities typically are long-term investments that are not susceptible to market volatility like publicly-traded securities. Although publicly-listed REITs/BDCs, for example, can be traded on an exchange and provide ready liquidity, they may be traded through "gamified" brokerage platforms, which may encourage poor investment decision-making.

Even with these liquidity constraints, the reputable asset management firms that sponsor non-listed REITs/BDCs have developed sophisticated means to provide some liquidity to their stockholders. As noted earlier, the typical NAV REIT/BDC offers its investors the opportunity to request redemption of their shares every month, up to a limit of 5% of NAV. Non-listed REITs/BDCs generally have multiple sources of liquidity, including a portion of their investment portfolios allocated to liquid securities that can be converted to cash to meet redemption needs.

The Division glosses over this redemption feature, again confusing traditional lifecycle REITs/BDCs with NAV REITs/BDCs. For example, on the very first page it proclaims that investors "cannot trade out of their shares after they have invested," ignoring the fact that investors have the opportunity to have their shares redeemed.

The Division asserts that during the pandemic, in April 2020, investors "could not tap into their investments because sponsors halted withdrawals,"[37] citing an article about a *lifecycle BDC* for this proposition. The first quarter of 2020 was one of the worst in the history of real estate and business loan investment. For example, publicly-listed equity REITs declined over 23% and publicly-listed mortgage REITs declined over 56% that quarter.[38] Publicly-listed BDCs presented an even steeper drop in the first quarter of 2020, declining over 44% by the end of the period. NAV REIT redemptions in general held up well during the pandemic. Estimated 2020 redemptions were in excess of $2.2 billion, with $75.7 million of unfulfilled redemptions reported as of September 30, 2020.[39] In other words, 96.56% of requested redemptions were redeemed. The ability of reputable REIT/BDCs to fulfill their redemption requests during such a period of market volatility – even though the underlying assets are relatively illiquid – is a testament to their management sophistication and acumen.

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[37] Division Letter at p. 7.

[38] *See* https://www.reit.com/data-research/data/quarterly-reit-performance-data.

[39] Two NAV REITs have suspended redemptions and thus do not provide an estimate of unfulfilled redemptions. Of those two, one suspended redemptions before the pandemic due to a change in its business model. The other was a small, newly formed mortgage REIT that suspended redemptions during the pandemic but has reactivated its share redemption program.


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The Division also seems to assert that illiquidity is bad in and of itself. This assertion ignores the fact that many illiquid investments contain an "illiquidity premium" that investors receive in return for their willingness to hold investments over a longer period of time. Most investors construct their portfolios to provide for short-, medium-, and long-term holding periods. It is entirely rational for an investor to sacrifice some liquidity in exchange for the potential of a higher return on funds that that they have no intention to access for a long period of time, and many financial professionals recommend REITs/BDCs to their clients for exactly this reason. A classic example is an investment made through Individual Retirement Accounts ("IRA"). Most investors do not intend to access funds in their IRAs for at least 25 years from the time of the investment. To suggest that the inability to liquidate any investment at a moment's notice is somehow nefarious is entirely misguided and ignores substantial academic and other research.

C. The "Fee" Myth

The letter argues that REITs/BDCs have "many different layers and types of fees" and that dealers must consider "lower cost alternatives," citing a 2016 article on *lifecycle* REITs/BDCs.[40] We acknowledge that investors incur fees to gain exposure to real estate and private credit in their portfolio, but the fees on today's products are not dissimilar to the fees in other widely used investment products, such as mutual funds. In fact, NAV REITs/BDCs are structured in a manner similar to mutual funds, offering multiple share classes that differ according to the amount and timing of upfront sales loads and ongoing distribution fees. Regulated broker-dealers and investment advisers are thus given the flexibility to recommend the class of shares that is in the best interest of their customer.

Most NAV REITs cap their total front-end sales charges and ongoing distribution fees at amounts up to 8.75% of gross proceeds and automatically convert the shares that have reached the cap into a class of shares that does not bear any fees. In the year-to-date through December 2020, only .8% of non-listed REIT shares sold had a full load commission, while 38.3% of sales were in low-load share classes and 61% of sales were in no-load share classes purchased on a fee-based platform.

There are two other types of expenses that are paid by the REIT/BDC, and thus are indirectly incurred by the investor. These expenses are also similar to those incurred by mutual fund investors. First, like mutual funds, REITs/BDCs do not have their own employees and must compensate their external advisors for providing the day-to-day management services, including the management of their investment portfolios. NAV REITs generally charge a 1.25% management fee on NAV (not on AUM) comparable, for example, to the 1.15% on Cohen & Steers Realty Share (i.e., their public REIT mutual fund). Second, REITs/BDCs must pay the organization and offering expenses, which are expenses related to the organization of the investment program and the distribution of the program, respectively. For example, the REIT/BDC will reimburse the dealer-manager for expenses it may incur in educating financial professionals about the features of the investment program and the terms of its offering. A difference in the fee structure from most mutual funds is that many NAV REITs include a performance incentive fee that is designed to align the interest of stockholders and fund management.

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[40] Division Letter at p. 2.


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Finally, broad categories of fees formally associated with REITs such as acquisition and disposition fees have been reduced or eliminated. Only the actual fees incurred in the management of the underlying real estate (such as appraisal, legal, or property management fees) may be incurred by the REIT. A mutual fund, in contrast, may incur trading and other fees.

The Division says that the sample REIT in its letter has "11 different types of product fees and expenses listed." The Division does not explain how it arrived at this number. It appears to have counted all of the upfront sales loads and distribution fees of each different share classes, even though no single investor will pay all of them. The Division also appears to have split out each type of reasonable expense such as the issuer organization and offering expense, the fixed component of the advisory fee, and the performance component of the advisory fee.

The Division's mischaracterization of the distributions, liquidity and fees of REITs/BDCs reflects the Division's irrational bias against those products. The IPA would be happy to dispel the Division's other mischaracterizations of these investments.

* * *

Thank you for your time and consideration of our response to the Division's letter. The Division's evasion of the JCARR and its clear bias against non-listed REITs/BDCs have had a significant impact on our membership and we sincerely appreciate the opportunity to clear up the mischaracterizations included in the Division's letter. If the IPA may be of any assistance, please do not hesitate to contact me or Anya Coverman, IPA's Senior Vice President, Government Affairs and General Counsel, at (202) 548-7190.

Sincerely,

Anthony Chereso
President & CEO, Institute for Portfolio Alternatives


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