Cover Story

Private Indexes in Advertising and Non-Traded REIT Valuations

By: Division Registration Section Staff

> ***[We are] concerned that, after a lifetime of accumulated savings, senior investors may meet the financial and risk threshold requirements to invest in more complex financial securities and that broker-dealers may be recommending unsuitable transactions to these senior investors or may not be providing proper and understandable disclosures regarding the terms and related risks of those recommended securities, particularly non-traditional investments.***
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> NATIONAL SENIOR INVESTOR INITIATIVE, A COORDINATED SERIES OF EXAMINATIONS
> The SEC's Office of Compliance Inspections and Examinations and FINRA
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> ***Our seniors are too often the ones with the money when it comes to Ponzis and other investment schemes in Ohio. The Division will continue working hard to make sure those individuals – who have worked a lifetime building assets and wealth for their families – are making informed investment decisions and better protected from fraud in our markets.***
>
> WORKING TOGETHER TO PROTECT OHIOANS
> Sheryl Maxfield
> 2019:1 Ohio Securities Bulletin.

An important goal of the Ohio Division of Securities is protecting senior investors from financial abuse and exploitation. As such, the *Ohio Securities Bulletin* regularly features articles about this important subject (recently in the 2015:1 issue[1], the 2018:2 issue[2] and the 2019:1 issue[3]) and the Division has prioritized educational efforts at senior-related events.

One area where many, including the elderly, are exploited is in the recommendation of unsuitable investments. Suitability problems arise where illiquid securities are sold to investors with strong liquidity needs; for example, seniors who need cash to cover medical or long-term healthcare costs. As we have written about previously, non-traded real estate investment trusts (non-traded REITs) are "generally illiquid investments with limited ability to redeem shares."[4] Brokers have a strong financial incentive to sell these products as they pay brokers "some of the highest selling commissions of any investment product available."[5] The SEC's National Senior

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[1] Brian Peters, *Senior Investors: Tips to Protect Them, and You,* OHIO SECURITIES BULL., 2015:1, at 5.
[2] Jaqueline Williams, *Protecting Ohio Seniors from Fraud*, OHIO SECURITIES BULL., 2018:2, at 1.
[3] Sheryl Maxfield, *Working Together to Protect Ohioans,* OHIO SECURITIES BULL., 2019:1, at 1.
[4] Securities and Exchange Commission, Office of Compliance Inspection and FINRA, *National Senior Investor Initiative, available at* https://www.sec.gov/ocie/reportspubs/sec-finra-national-senior-investor-initiative-report.pdf (last visited April 2, 2020).
[5] Ohio Division of Securities, *Suitability Requirements in Direct Participation Programs,* OHIO SECURITIES BULL., 2013:2.

Investor Initiative noted non-traded REITs are among the top revenue-generating (i.e. commission-generating) securities sold to senior investors.[6]

In addition to liquidity challenges, non-traded REITs may underperform their traded counterparts, i.e., listed REITs traded on national exchanges, injecting another suitability hurdle brokers need to pass in recommending these products. One study featured in the SEC's Appendix to its recent Regulation Best Interest final rule concluded "[n]on-traded REITs are so inferior to traded REITs that no advisor taking due care could develop a reasonable basis for recommending a non-traded REIT."[7]

In view of the foregoing illiquidity and performance issues coupled with the fact non-traded REITs are proactively marketed and sold to seniors, the Division closely scrutinizes product advertising in this space. In particular, the Division has questioned marketing advertising non-traded REITs as fixed-income investments with regular distributions and little to no volatility (or having no correlation to the stock market). The Division has also questioned advertising claiming non-traded REITs outperform (or perform similarly to) other asset classes, such as the S&P 500, or bond indexes. For the reasons explained below, the Division objects to advertising that would tend to mislead investors, especially seniors, about non-traded REIT valuations and performance.

Non-Traded REIT Valuations

Non-traded REITs often advertise their net asset values (or NAVs) as having little or no volatility when compared to other asset classes. Essentially, the message these marketing pieces try to convey is non-traded REITs add protection from market volatility. It is important for investors to understand non-traded REITs are not immune to fallout from market volatility and NAVs can be – and often are – vastly different than the amount of money investors receive if and when they sell their shares. Investors considering these products should know:

- **Non-traded REITs *are* impacted by market volatility**
  The market volatility we are currently experiencing is having a direct impact on non-traded REITs. For example, Moody National REIT II, Inc.,[8] Procaccianti Hotel REIT, Inc.,[9] and InPoint Commercial Real Estate Income, Inc.[10] have all recently suspended their share redemption programs, meaning financially distressed investors will be unable to liquidate their shares to leverage those assets.
- **NAVs do not always hold up when REITs are publicly listed**
  Even in less volatile markets where non-traded REITs are successfully converting to public listings, NAV may be misleading. There are many examples of non-traded REITs whose

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[6] Securities and Exchange Commission, *supra* footnote 4; *see also,* Paul J. Seguin, The Relative Value of Public Non-Listed REITs, J. OF REAL ESTATE RES., Vol 38(1) 59, at 87. (opining the "only plausible explanation [for the sale of most non-traded REITs is] the high front-end commissions or returns-to-dealer are sufficient for broker dealers to sell or 'push' these investments on the investing public").

[7] Craig McCann, Fiduciary Duty and Non-Traded REITs, INVESTMENTS AND WEALTH MONITOR, July/Aug. 2015, at 39, available at https://www.slcg.com/pdf/workingpapers/Fiduciary%20duty%20and%20Non-traded%20REITs.pdf; Securities and Exchange Commission, Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed Reg 33,318, 33,431 n. 1112 (July 12, 2019) (codified at 17 C.F.R. Pt. 240);

[8] Moody National REIT II, Inc. Supplement No. 9 to the Prospectus (Form 424b3) (March 25, 2020), *available at* https://www.sec.gov/Archives/edgar/data/1615222/000138713120003231/mnrtii-424b3_032520.htm.

[9] Procaccianti Hotel REIT Inc., Supplement No. 9 to the Prospectus (Form 424b3) (March 20, 2020), *available at* https://www.sec.gov/Archives/edgar/data/1692345/000110465920036910/tm2012985d1_424b3.htm.

[10] InPoint Commercial Real Estate Income, Inc., Supplement No. 13 to the Prospectus (Form 424b3) (March 27, 2020), *available at* https://www.sec.gov/Archives/edgar/data/1690012/000156459020013341/ck0001690012-424b3.htm.

share prices crash upon being publicly listed. For example, consider the example of American Finance Trust, Inc. (AFIN), a non-traded REIT listed on the NASDAQ Global Select Market. Before listing, AFIN valued its estimated value per share based on NAV at $23.56. Following the first day of trading, the market priced the shares at $15, a single-day drop of over 35%.[11]

- **Non-traded REIT valuations do not display a "liquidation discount**"
  In efficient markets, non-traded REITs would be expected to lower or discount their share prices as compared to their listed counterparts, which can be liquidated at any time. One study estimated this difference should reflect a 12% to 13% pricing discount.[12] Non-traded REITs do not display this discount.
- **NAV may not incorporate all fees**
  Non-traded REITs pay substantial fees including upfront fees, dealer manager fees, incentive fees, liquidation fees, stockholder servicing fees, and substantial ongoing fees thereafter.[13] Many of these fees are not incorporated into the NAV calculation.
- **NAV is tainted by advisor's valuation determination**
  Non-traded REIT advisors face a conflict of interest by earning a management fee based upon the valuation of assets. This is problematic as these advisors are the same parties responsible for calculating the REIT's NAV.

Private Indexes and their use by non-traded REITs.

In recent years, non-traded REIT sponsors have turned to private indexes of non-traded REIT returns to promote their performance. The two most common indexes are published by the National Council of Real Estate Investment Fiduciaries ("NCREIF"[14]) and the Stanger Return Indexes.[15] Both compile the performance of non-traded REITs, typically by combining NAV/price appreciation and distributions/cash flow yield. The sponsors of non-traded REITs use these indexes to advertise non-traded REITs as outperforming other asset classes. Investors should know:

- **Non-traded REITs have historically underperformed their traded counterparts**
  In the Securities Litigation & Consulting Group study, researchers found investors "would have had 50% more wealth had they invested in a diversified portfolio of traded REITs instead of the … non-traded REITs."[16] The researchers attribute this to the high upfront fees

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[11] Press Release, American Finance Trust, 2018, *American Finance Trust Successfully Completes First Day of Trading On Nasdaq* (July 19, 2018).

[12] Seguin, *supra* footnote 7 at 85.

[13] Bohjalian, *The Truth About Non-Traded REITs*, COHEN & STEERS INSIGHT, November 2018, *available at* https://assets.cohenandsteers.com/assets/content/resources/insight/ED2049_TruthAboutNon-TradedREITs.pdf at 2 (stating that "[s]ome NTRs now offer share classes with low or no up-front sales charges. However, recurring fees are still significantly higher than those of most active REIT managers, generally 2.75% until a maximum total servicing fee is achieved. NTR advisers will also generally take a promoted interest of around 10–15% once the leveraged return exceeds a specified threshold, usually 5–7%. By contrast, the typical total expense ratio for an actively managed U.S. REIT mutual fund is just 1.15%.").

[14] NCREIF seeks to calculate the total return for private real estate, where "return" includes both income (i.e. cash flow yield) and price appreciation/depreciation of real estate assets. *See, e.g., Data Products,* NATIONAL CONFERENCE OF REAL ESTATE INVESTMENT FIDUCIARIES, https://www.ncreif.org/data-products/ (last visited Apr. 2, 2020).

[15] The Stanger Lifecycle REIT Total Return Index and The Stanger BDC Total Return Index measure overall industry performances on a quarterly basis. *Publications*, STANGER INVESTMENT BANKING, https://www.rastanger.com/publications/ (last visited Apr. 2, 2020).

[16] Brian Henderson, et al., An Empirical Analysis of Non-Traded REITs, THE J. OF WEALTH MGMT., Summer 2016, at 39, available at https://www.slcg.com/pdf/workingpapers/Henderson%20Mallett%20McCann%20non-traded%20REITs.pdf.

and expenses and significant conflicts of interest, which are not adequately factored into private index analyses.

- **Investors do not have access to the underlying data**
  These indexes are private and the analytical tools and computational formulas are "available to … members only."[17] As investors do not have access to the underlying data, they do not have the opportunity to research or analyze how these figures are computed. This is especially troubling as "non-traded REITs on the other hand are illiquid, making the data gathering required for empirical research extremely time consuming." [18]
- **Indexes may display an "appraisal lag"**
  An industry consultant also observed the unique phenomenon of "appraisal lag" when viewing non-traded REIT results from these indexes in tandem with listed REIT returns. As he notes, "today's [listed] REIT returns foretell the NCREIF returns that will be registered roughly 18 months from now."[19]
- **Distributions are often funded from sources other than cash flow**
  Private indexes report the "return" of non-traded REITs as a combination of cash flow yield and price appreciation. Non-traded REITs distribute cash flow through distributions, but these distributions come from sources other than operations. One major distribution source is a return of capital, which is simply giving investors a portion of their *money back*. As the SEC wrote, *"[n]on-traded REITs may use offering proceeds, which includes the money you invested, and borrowings to pay distributions. This practice reduces the value of the shares and reduces the cash available to the REIT to purchase real estate assets."*[20]
- **Indirect forecast performance**
  These claims indirectly forecast greater return and reduced volatility/risk, sometimes with hypothetical portfolios, resulting from a significant direct investment in the Issuer. There can be no assurance investors will receive the returns assumed by either the fixed income and equities allocation or an investment in the Issuer will perform similarly to an index.
- **Faulty apple-to-orange comparisons**
  The indexes rely on historical, self-reported figures. The problem is historical data for established reporters of asset values likely is irrelevant in predicting the performance of an issuer with little to no operating history. That is especially true where the historical data involves a wholly different type of real estate; for example, the scenario where a non-traded REIT invested in a "niche" portfolio of senior or student housing inappropriately relies on index data involving hotel and resort properties. While the issuer may note these contradictions in footnote disclosure to comply with FINRA Rule 2210,[21] it is the favorable valuation and not the disclaimer that is touted to the investor. Some comparisons have too many or significant differences to be solved by footnote disclosure and must be removed.

Conclusion

The Division has objected, and will likely continue to object, to the use of private indices in investor or retail-use sales literature because such claims tend to deceive investors. Investors should be skeptical about claims non-traded REITs have no or limited volatility and should remember redemption programs are ultimately at the discretion of the Boards of non-traded

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[17] Data Products, *supra* footnote 14.
[18] McCann, *supra* footnote7.
[19] Pete Linneman, *The Return of Publicly and Privately Owned Real Estate*, WHARTON REAL EST. REV., Fall 2004, at 9, *available at* http://realestate.wharton.upenn.edu/wp-content/uploads/2017/03/493.pdf.
[20] U.S. Securities and Exchange Commission, Investor Bulletin: Non-Traded REITs, August 31, 2015, https://www.sec.gov/oiea/investor-alerts-bulletins/ib_nontradedreits.html.
[21] FINRA rule requires comparisons to "disclose all material differences between investments." -FINRA Rule 2210(d)(2) (Communications with the Public).

REITs. As is being observed now, programs will suspend share redemption plans during periods of loss or extreme volatility. Indeed, nearly all Direct Participation Programs (which include non-traded REITs) involve:

> "substantial risks, including severe restrictions on liquidity that may lock-in investors indefinitely, complicated corporate structures that pose potential conflicts of interest for management, upfront fees and expenses … substantial ongoing fees thereafter, leverage ratios that may exceed 300% of net assets, and distributions to shareholders paid from borrowings or a return of the shareholder's investment after deducting fees paid to insiders."[22]

The Division urges investors to approach these investments with caution. If you have specific questions regarding any of the topics discussed in this article, please contact the Registration Section at 614-466-4375.

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[22] Ohio Division of Securities, *supra* footnote 5.