Finra's Proposed Nontraded REIT Rule Changes Could Have Gone Further

Publication / Date Published: Investment News Online (www.investmentnews.com) / October 3, 2014

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Finra's proposed rule changes affecting nontraded real estate investment trusts have some very helpful elements. They would provide guidance and uniformity on nontraded REIT valuations and require valuing the share price much earlier in the fund-raising process than was previously mandated. This is an important check on the sponsor companies, and a helpful protection for investors and advisers. The proposed change also codifies the formula for independent valuations, providing both timely and standardized information to investors.

However, I think the proposed rule change with regard to statement reporting adds more confusion than clarity. The rule could have gone much further to protect investors and advisers by obtaining agreement and broad-based support from sponsor companies, broker-dealers, RIAs and registered representatives to lower fees, in lieu of merely disclosing some of the embedded costs of acquiring real estate through a share price reduction on statements.

Rather than substituting one flawed valuation metric for another, and with buy-in from the entire community, the rule change could have actually produced more value for investors. If the fees were actually lowered and not just disclosed on statements, we would have realized that additional benefit of wrapping this valuable asset class in a leaner structure that would be more attractive to RIAs and lead to broader acceptance and utilization by more investors.

Instead, part of the proposed "solution" substitutes one arbitrary valuation of nontraded REIT shares for another. This approach ignores some industry best practices, and raises at least three unintended consequences:

"With buy-in from the entire community, the rule change could have actually produced more value for investors." - Frederick Baerenz, president and CEO of AOG Wealth Management.

1) **Investors who would prefer to "prepay" their adviser compensation (through a commission rather than being billed in an RIA account) or who may want more income and less growth (buying at NAV in an RIA account will purchase more shares, but pay less income after fees) will be unduly punished or influenced with nonrealized losses shown on a statement.** It is one thing to know that a load must be overcome before selling for a profit, and quite another to face red ink quarter after quarter while the sponsor company attempts to grow the net operating income to justify an appraisal value that will move the investment back to par.

2) **In this period of high correlation across all equity classes, where even traded REITs closely track the S&P and provide almost no low or negative correlation protection, the pricing issue may discourage the utilization of an important product/asset class.** Studies have shown the historical record of nontraded REITs simultaneously lowering risk and potentially increasing returns. Why would we discourage utilizing such a tool that would be helpful to almost any investment portfolio?

3) **The proposed changes for statement valuations will likely confuse the investing public rather than clarify any issues.** People who purchase real estate as a medium to long-term hold (e.g. a nontraded REIT or a residential home) know that there is a "load" factor, and if they sell in the short term, they are unlikely to get all their money back due to transactional fees. In a normal housing market, someone who purchases a residence for $100,000 knows that if they sell in their first year of ownership, they will pay real estate commission, settlement costs and borrower fees, and likely only get back about $90,000. People already understand this concept.

A practical solution to some of the unknown quantities associated with alternatives would consist of the below points. To wit, a "best practice guideline" that actually reduces the cost to investors would be helpful. Among the positive practices adopted by market leaders are the following:

- Eliminating the "internalization fee" whereby sponsor companies were paid "bonuses" to carve out REIT management teams from the sponsor companies and allocate the team exclusively to the REIT.
- &bull: Reducing the fee charged to acquire portfolio assets from 3% of the purchase price to 1%.
- Eliminating the 1% fee charged for arranging financing
- Reducing the annual fee for general administration by 1% or more (in many cases, the fee is taken in the form of restricted stock, allowing the cash to be utilized for asset acquisition).

In conversations with senior Finra officials, I have been informed that this matter is largely settled. It is expected that the SEC will issue new rules including the formula for statement reporting net some of the load in the next few weeks. I know that the industry has worked through very complicated issues to improve the process for all stakeholders. Since no economic impact study was performed, we can only hope that a provisional rule will be adopted for statements, and that Finra will review the process annually and be willing to revisit the question if the negative consequences are realized.

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