July 21, 2015

Submitted Electronically – e-ORI@dol.gov and e-OED@dol.gov

Office of Regulations and Interpretations
Office of Exemption Determinations
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Ave., NW
Washington, DC 20210

Re: Definition of the Term "Fiduciary" (RIN 1210-AB32); Best Interest Contract Exemption (ZRIN 1210-ZA25)

Ladies and Gentlemen:

The Investment Program Association ("IPA") submits the following comments with respect to the rule proposed by the U.S. Department of Labor (the "Department") which would define who is a "fiduciary" by reason of providing investment advice for a fee or other compensation (the "Proposed Conflict of Interest Rule"[1]) and the related proposed Best Interest Contract Exemption (the "Proposed BIC Exemption"[2]). The IPA appreciates the opportunity to comment on this important regulatory action.

The IPA was formed in 1985 to provide effective national leadership for the direct investment industry. The IPA supports individual investor access to a variety of asset classes not correlated to the traded markets[3] and which have historically been available primarily to institutional investors. These include publicly registered, non-listed real estate investment trusts ("NL REITs"), publicly registered, non-listed business development companies ("NL BDCs"), and other publicly registered, non-listed direct participation programs (the "Other DPPs"), and collectively with NL REITs and NL

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1 U.S. Department of Labor, Notice of Proposed Rulemaking, *Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice*, 80 Fed. Reg. 21960 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pt. 2550), available at: http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28201.

2 U.S. Department of Labor, Notice of Proposed Class Exemption, *Proposed Best Interest Contract Exemption*, 80 Fed. Reg. 21960 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pt. 2550), available at: http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28202.

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

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BDCs, the "Public Products"[4]). These Public Products are more fully described below. For 30 years the IPA has successfully championed the growth and improvement of such products, which have increased in popularity with financial professionals and investors alike. Public Products are now held in more than 2.8 million investor accounts. Today, Public Products function as a critical component of effectively diversified investment portfolios and serve an essential capital formation function for the U.S. economy.

The IPA serves the investment community through advocacy, collaboration, and education regarding these "direct investments".

- The IPA supports individual investor access to professionally managed asset classes and strategies which have historically been available primarily to institutional investors.

- IPA members include 150 product sponsors, asset management companies, broker-dealers, and direct investment service providers, including major national accounting and law firms and national, regional and independent broker-dealer firms. Collectively, these members service financial and direct investment assets in virtually all investment categories, including Public Products representing over $125 billion of assets under management.[5]

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

    - Promoting uniform and comparable reporting of product performance information;
    - Standardizing valuation and financial metric reporting among direct investment products;
    - Enhancing overall product transparency beyond what is required to be disclosed in filings with the Securities and Exchange Commission ("SEC");
    - Working directly with federal and state regulators (e.g., the SEC, the Financial Industry Regulatory Authority, Inc. ("FINRA") and the North American Securities Administrators Association

4 The IPA supports additional products that are not discussed herein.
5 A complete list of the IPA's members is available at: http://www.ipa.com/membership/directory-of-members/.

("NASAA")) to help create consistent and transparent communications and regulations for Public Products;

- Raising investor understanding of Public Products and their potential to address individual financial goals through educational programs; and
- Training investment advisers to enhance their knowledge of Public Products and the appropriate role of these products in client portfolios.

EXECUTIVE SUMMARY

The IPA's primary concerns relate to two issues: (i) the Department's apparent substitution of a "legal list" of acceptable (and presumably "worthy") assets in place of its traditional principles-based approach; and (ii) the definition of "Assets" in the Proposed BIC Exemption. With respect to item (ii), the Department has requested comment on the proposed definition of "Assets" and has specifically asked that commenters who believe that additional investments should be included in the scope of the exemption provide the Department with full descriptions of those products, as well as information supporting the position that the products are a "common investment for retail investors."[6]

The IPA respectfully submits that the retreat from a principles-based approach to a "legal list" of "Assets" available to retirement investors for the purpose of the Proposed BIC Exemption will stifle product innovation and deny retirement investors the ability to access new investment categories, structures and products which may provide enhanced financial benefits and/or reduced risks. To avoid the negative consequence of this approach, the Department must have the ability and resources to regularly, continually, and timely consider and analyze new investment products for inclusion as an Asset, which may not be practicable. As a result, the Asset list process will create a category of investors who are not able to take advantage of market evolutions and improvements. The IPA therefore believes the "Asset List" approach should be discarded in favor of a principles-based approach.

The IPA also respectfully submits that if the Department determines to proceed with an "Asset List" approach, then Public Products, as defined and described herein,

[6] Proposed BIC Exemption, 80 Fed. Reg. 21967.

should be included in the "legal list" of Assets. This position is supported by the following observations:

- Public Products complement the objectives of retirement investors in that they can provide superior income and inflation protection, as well as capital appreciation.

- Public Products provide retirement investors with access to strategies similar to those used by the nation's leading public and private pension and endowment plans in that they provide portfolio diversification into assets which have low correlations with exchange-traded financial products, thereby reducing portfolio risk and increasing risk-adjusted returns.

- Public Products have evolved from their predecessor forms and structures to provide improved liquidity, more transparency and independent valuation discovery, enhanced governance, more investor-friendly structures and compensation provisions, greater scale and associated financial strength, efficiency, strategic optionality, and superior professional management focus on the products' distinct asset class.

- Public Products are subject to extensive regulation at the federal and state level which goes far beyond the regulatory oversight of many products on the Department's proposed Asset List.

- Public Products have generally demonstrated successful investment performance and achievement of investment objectives which are appropriate for retirement investing.

- Public Products have established themselves as integral components of over 2.8 million investment and retirement accounts.

Despite the foregoing, none of the Public Products have been included in the Department's proposed list of Assets, and this will have the impact of effectively making these publicly registered investments unavailable to qualified IRA investors. The IPA

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believes that Public Products[7] should be included as "Assets" within the Proposed BIC Exemption either by the removal by the Department of a "legal list" of Assets or by the inclusion of the Public Products on the "legal list".

The following pages provide more in-depth descriptions and details of these Public Products and the IPA's recommendations with respect to the Department's proposal. For ease of reference by the Department, this letter is organized as follows:

I. Public Products Complement Retirement Investment Objectives

The IPA believes that Public Products possess attributes that are highly compatible with, and in fact complement, retirement investment objectives, the

[7] The descriptions of the Public Products included in this comment letter are general in nature. Some individual Public Products may vary from the examples described herein with respect to distribution method, structure, and internal compensation arrangements. We believe, however, that the descriptions provided are representative of the vast majority of existing products.

recognition of which has resulted in these products rapidly gaining advocates among financial advisors and investors. These products can:

- Provide Superior and Reliable Income Distributions. Public Products are typically designed to provide a significant majority of their returns in the form of a stable stream of income which can help sustain a retiree's lifestyle during retirement.

- Focus on Current Return, Not Speculative Growth. By focusing their investment objectives on providing a majority of their return in the form of current income, retirement investors using Public Products avoid the risks inherent in more aggressive or speculative products which seek a rapid growth of capital.

- Provide the Potential for Inflation Protection. Inflation is a significant risk to retirement income and the purchasing power of saving. Unlike bond and fixed income portfolios where the purchasing power of invested capital can be eroded by inflation, the asset-based Public Products can provide capital protection through appreciation of value of the underlying assets induced by inflation.

- Avoid Exposure to the Volatility of Traded Securities Markets While Providing a Measure of Liquidity. By investing directly in real assets, Public Products help investors avoid over-concentrating their portfolios in exchange-traded securities or pooled-investment vehicles which invest in exchange-traded securities, thereby helping diversify investor portfolios and reduce the volatility and market risks associated with holding too much of such products.

  For example, exchange-trade REITs clearly play an important role in providing individual investors with access to diversified and professionally managed portfolios of high quality commercial real estate. The IPA supports the efforts of organizations such as the National Association of Real Estate Investment Trusts to foster public knowledge and investment in exchange-traded REITs. The IPA believes, however, that investment portfolios can be more effectively diversified when the form of real estate investments includes both traded and non-traded vehicles. Indeed, it is noteworthy that major institutional pension plans historically have utilized investment strategies that call for investment in both exchange-traded REITs and direct real estate investments. This strategy helps insulate institutional portfolios from the volatility which can occur in exchange-traded securities markets. For example, the RMZ Price Index of exchange-traded REITs has experienced a one day decline as high as 19.7% and value swings exceeding 5% on 4.6% of all trading days in the past ten years (approximately equivalent to one such swing every twenty trading days). It is important to note that volatility of this magnitude is not unique to exchange-traded REITs but applies to numerous subcategories of exchange-traded securities which are included in the Department's proposed Asset List. Historically, the volatility of exchange-traded securities markets has tended to induce retail investors to sell securities at times of declining market prices and purchase securities at times of increasing market prices, as demonstrated in Morningstar's Investor Return metric. While such volatility is the tradeoff for the benefit of total liquidity, Public Products have increasingly introduced features (as described below) which provide liquidity, albeit on a more limited basis than exchange-traded securities, combined with greater price stability.

Volatility can be particularly detrimental to retirement investors whose retirement portfolios are concentrated in exchange-traded securities and pooled-investment products which invest in exchange-traded securities and who have begun regular withdrawals to sustain their lifestyles or comply with IRS required minimum distributions. For these investors, when the value of their portfolio has been temporarily depressed due to market volatility yet they need to take distributions, such distributions will represent a greater proportion of their retirement savings, thereby reducing the future income-generating potential of their retirement savings, and compromising their lifestyles.

- Enable the Assembly of More Effectively Diversified, and Therefore More Stable, Investment Portfolios by Retirees. Public Products provide individual investors with access to "direct investments" which for years have been a fundamental component of the investment portfolios of institutional pension plans and endowments. These institutional investors, operating under "prudent investing" principles, have long recognized the tenets of Modern Portfolio Theory. This theory, first described by the Nobel prize-winning economist Harry Markowitz and subsequently confirmed through observation and quantitative analysis, states that investors can achieve superior risk-adjusted returns by combining assets that have different risk characteristics. This combining of assets can result in a portfolio with less risk than the individual assets comprising it, without sacrificing return potential. A key determinant of the amount of risk reduction is not just the number of assets combined, but more importantly their "correlation." Two asset classes whose returns move in parallel (*i.e.*, when one goes up, the other goes up) are said to have a positive correlation; if their returns move in opposite directions they have a negative correlation. Markowitz's great contribution to investors' wallets was his demonstration that anything less than perfect positive correlation can potentially reduce risk.[8]

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

II. Evolution of Public Products to Become "Common" Investments With Investor-Friendly Features

In response to competition, market forces, and evolving regulation, Public Products have evolved to become a dramatically more investor-friendly form of investment today than the publicly registered, non-listed direct participation programs (*e.g.*, limited partnerships) of the 1980s. Among these evolutionary and pro-investor changes are:

- <u>Introduction of Liquidity Features</u>. Public Products have limited lives and typically seek a liquidity event within a five to ten-year holding period. Such a liquidity event can include a listing of the company on a national exchange, a merger with an existing exchange-traded company, or a sale of the assets of the company. Although some Public Products are traded on a limited basis in informal secondary markets prior to the ultimate

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

liquidity event, the product has evolved to provide limited share redemption programs ("SRPs") for investors who confront unexpected financial needs. SRPs allow for early redemption of an investor's interest in advance of the product's final liquidity event. Although these programs are discretionary on the part of the fund, the typical NL REIT SRP will accommodate the redemption of 5% of the number of shares outstanding each year and the typical NL BDC SRP will accommodate redemptions of up to 10% per year. A recently introduced form of Public Product that is gaining momentum in equity fundraising, the Daily NAV REIT, will accommodate the redemption of up to 20% of the REIT's net asset value each year – indicating an on-going trend toward the provision of greater liquidity among Public Products.

While the terms and limitations may vary, SRPs typically require a minimum hold of one year, except for redemptions upon the death or disability of the investor. Pricing of share redemptions typically ranges from 92.5% to 100% of either independently appraised value of the security or purchase price, depending on timing and circumstance, and often at a lower discount from purchase price or net asset value ("NAV") the longer the security is held. Death and disability hardship redemptions are typically priced at 100% of NAV or purchase price regardless of the holding period.

- <u>Improved and Transparent "Price" Discovery</u>. Public Products provide investors with significant "price" (*i.e.*, value) transparency via both regulatory requirements and industry valuation and disclosure guidelines issued by the IPA. These factors assure investors have transparency as to value and ability to redeem shares at a fair price. FINRA Rule 2310 stipulates that a broker-dealer may not sell a publicly registered direct participation program or NL REIT security unless the issuer agrees to provide a valuation in its annual report (or other public filing). Recent changes to NASD Rule 2340 will impose additional transparency requirements for all of these Public Products relating to the reporting of their values on customer account statements and requiring the material involvement and confirmation of such reported values by valuation experts.

Rigorous standards also exist for the determination of valuations among Public Products. For example, NL BDCs provide investors with significant value transparency in accordance with regulatory valuation requirements for companies registered under the Investment Company Act of 1940 (the "1940 Act"). These valuation requirements for NL BDCs are well established in the accounting community. NL BDCs must perform quarterly valuations, publish their net asset value in periodic reports filed with the SEC, and disclose the identity, valuation and other pertinent information regarding each asset in their portfolio.

NL REITs must also provide value transparency due to regulatory requirements for DPPs and NL REITs relating to the presentation of valuations for such products on broker-dealer customer account statements. For NL REITs, the IPA issued "IPA Practice Guideline 2013-01: Valuations of Publicly Registered Non-Listed REITs." This guideline sets forth standards relating to the basis of value (net asset value), methodology, independence of valuations, management of the process of conducting valuations, and enhanced reporting and disclosures relating to valuations. This guideline adopted the basis for valuation reporting used by institutional real estate investors, with the valuation determined consistent with the definition of fair value under generally accepted accounting principals ("GAAP") – an adherence to GAAP consistent with the Real Estate Investment Standards sponsored by the National Council of Real Estate Investment Fiduciaries ("NCREIF") and the Pension Real Estate Association ("PREA"). Likewise, Public Oil and Gas Partnerships must follow not only the requirements FINRA has established with respect to the pricing of securities on account statements but also requirements established by the SEC for the valuation of their reserves (the primary determinant in the valuation of partnership interests), typically utilizing the services of independent petroleum engineers to do so.

- Enhanced Governance and Reductions of Conflicts of Interest. As explained more fully herein, Public Products typically have more robust investor protections than the publicly offered partnerships of the 1980s due to improved governance provisions and limitations on conflicts of interest. For example, NL REITs and NL BDCs have boards of directors elected by shareholders and typically require majority approval by independent directors for actions which impact shareholder rights, strategic transactions, or transactions involving affiliates. Additionally, for NL REITs and NL BDCs the structure and duties of boards of directors is dictated by state corporation or trust laws, NASAA Guidelines, and, in the case of NL BDCs, 1940 Act requirements.

- Robust Regulation Beyond That of Many Products on the Asset List. As is described in greater detail below, all of the Public Products and those who sell them are subject to significant levels of regulation by the SEC, FINRA[9] and the securities regulators of the states in which those products are sold. While the regulations differ depending upon the specific product, in general, the regulation of Public Products addresses topics such as: disclosures (*e.g.*, product details, risks, conflicts, fees, and expenses); portfolio composition and permitted leverage; director qualifications and independence; limitations on transactions with affiliates; limitations on distribution costs, and organizational and operating expenses; limitations on compensation payable to the general partner or external advisor and affiliates which provide management services related to the acquisition, operation, and disposition of the assets of the investment entity; and the imposition of investor suitability standards (*e.g.*, minimum investor income and net worth requirements; a requirement that broker-dealers selling the products assess the suitability of the products for the investor, and limitations on the amount of liquid net worth an investor may invest in a particular category of product, commonly sponsored products, and/or individual products).

  In addition, unlike many of the products currently proposed for the Department's Asset list, Public Products: (i) cannot be purchased directly by the investor without the involvement, product due diligence, and investor suitability evaluation performed by a broker-dealer; and (ii) are subject to review in all states and "merit review" in approximately forty states. Merit review involves inquiry and subjective determinations by the individual state regulators as to the fairness of the offering to investors in that state. Merit state regulators have the authority to refuse to declare the securities registration effective in their state if, in the administrator's view, the offering is deemed to be "unfair, unjust or inequitable."

- Successful Investment Performance. A recent independent study of the performance of NL REITs which have fully liquidated (these NL REITs represent over $51 billion of original equity investment) indicated that these products on average outperformed the S&P 500 Index during matched holding periods, with the NL REITs providing average annual returns of 8.45% compared with the S&P 500 Index annual return of

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

7.68%. During their holding periods, these NL REITs provided investors with stable income in the form of average annual cash distributions equal to 7.05% of the amount invested.[10] (Broad-based studies of NL BDC performance are not yet available because of the relatively recent introduction of this product into the direct investment market (2009), allowing sufficient time for only one NL BDC to have completed its final liquidity event.)

- Enhanced Professional Management Expertise. Public Products have attracted "institutional quality" professional asset management companies with exceptional qualifications in the areas of their asset focus. Such institutional asset management companies have recognized the growing use of these products among retail investors who are increasingly seeking the security of their individually controlled retirement savings instead of defined benefit plans. This growing influx of such highly experienced and successful management organizations has contributed to the growth of investment in Public Products.

- Greater Efficiencies of Scale, Financial Strength and Strategic Optionality. Public Products today are significantly larger than their predecessor products. For example, the equity among the 35 fully liquidated NL REITs which comprised the above-referenced performance study averaged approximately $1.36 billion over the life of the NL REIT. Initial offerings typically register between $1 billion and $2 billion of securities. It is not uncommon for NL REITs or NL BDCs to have upwards of $3 billion of equity investment under management. These larger sized asset-based enterprises provide enhanced operational efficiencies and more financing resources and options. In addition, companies of this size have more optionality when considering liquidity events in that they not only can sell their portfolios over time, but also are attractive yet financeable merger targets and have the critical size necessary to list their securities on a national exchange. These greater efficiencies, in turn, have put downward pressure on costs and fees associated with Public Products.

[10] "Returns in the Nontraded REIT Industry: Evidence from Full-Cycle Events," Blue Vault Partners, LLC; Hartzell, Jay C., Real Estate Finance and Investment Center, Mccombs School of Business, the University of Texas at Austin; and Kim, Jung-Eun, the Department of Finance, Terry College of Business, University of Georgia, November 2014.

These and other reasons have propelled Public Products to become a "common" investment for retail investors, including IRAs, as evidenced by these statistics:

- Annual investment in Public Products has increased from $920 million in the year 2000 to over $21.1 billion in 2014.

- Approximately 30% of all public equity issuance (including initial and secondary offerings, which financed the purchase, development and improvement of U.S. commercial real estate) by real estate investment entities since the year 2000 has been issued by NL REITs. During the same period, NL REITs raised over $124 billion compared with $39 billion of exchange-traded equity REIT IPOs These facts confirm not only the significance of this product relative to exchange-listed public real estate investment trusts, but also its important role in real estate capital markets and our economy as a whole.

- Of a cumulative total of over $140.6 billion invested in Public Products since 2000, $58.8 billion was invested in the past three years, evidencing the rapid growth of recognition of the value of these investments in diversified portfolios.

- Of the $21.1 billion invested in Public Products during the year 2014, 43% was invested by IRA accounts.

- Public Products currently own and operate approximately $125 billion of assets under management.

- Over 30,000 financial advisors regularly recommend Public Products for their clients' portfolios.

- Public Products are held in over 2.8 million investor accounts, including 1.2 million IRA accounts as of December 31, 2014. The number of IRA accounts invested in Public Products has nearly doubled since 2011.

- Public Products provided over $5.9 billion of income distributions to investors in 2014, of which over $2.5 billion went to IRA accounts.

III. Overview of Product Structures and Purpose

A. Public, Non-listed Business Development Companies

NL BDCs are a type of public, closed-end investment company, typically organized as a corporation or trust, that specialize in lending to domestic private companies and small and middle-market public companies. NL BDCs may also make equity investments in companies, but primarily make loans with the goal of generating current income for their investors. NL BDCs typically invest the majority of their capital in companies with significant balance sheets and revenues and a record of generating positive earnings. Investors receive regular distributions (generally, monthly or quarterly). The life span of an NL BDC is typically five to ten years, after which an NL BDC may choose to list its shares, merge, or sell its assets to provide full liquidity to investors. NL BDCs serve an increasingly critical role in today's capital markets by providing much needed capital to the expanding middle market at a time when bank lending to these business enterprises has significantly contracted.

NL BDCs enable retail investors who meet certain suitability standards to participate in highly-regulated, transparent, and broadly diversified private debt and private equity investment opportunities that typically have been available only to wealthy individuals and institutional investors such as university endowments, foundations, and pension funds. Direct access to NL BDCs serves to enhance mainstream investors' portfolios by providing "endowment-style" investment strategies, which help construct more diversified portfolios and manage investor risk by decreasing correlation with the traded equity markets.

B. Public, Non-listed Real Estate Investment Trusts

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

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

C. Other Direct Participation Programs

Direct Participation Programs, as defined in FINRA Rule 2310, also include other publicly registered products which focus on a variety of asset-based and business lending areas. Currently, these other DPP Products include approximately $5.8 billion of public securities offerings currently in the market in such areas as oil and gas, equipment leasing, and impact lending. Like NL REITs and NL BDCs, all of these products are regulated by the SEC and FINRA as well as being subject to state securities regulations, including guidelines adopted by the North American Securities Administrators Association[11] ("NASAA Guidelines").

The following paragraphs provide brief summary descriptions of each of the Direct Participation Program categories currently offered in the market and their regulation and general fee structures. (Additional detailed information is available from the IPA upon request.)

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[11] NASAA is the umbrella organization of securities regulators from all U.S. states, territories, and districts, as well as Canada and Mexico, which issues statements of policy relating to various financial products which are designed to protect investors and seeks to coordinate certain requirements with federal securities law. (http://www.nasaa.org).

- Public, Non-listed Oil & Gas & Energy Partnerships ("NL Energy Partnerships"). These products provide individual investors with the opportunity to own interests in partnerships or limited liability companies which own oil and gas reserves or producing or non-producing properties. Investors receive cash distributions from income generated through the sale of oil and gas. While conducting business and owning assets in a fashion similar to many publicly traded energy companies, these partnerships are designed to mitigate for investors the volatility of traded energy securities markets while providing the potential benefits of energy asset ownership and diversification with securities which have low correlations to financial asset markets.

  Oil and gas partnerships may be broadly categorized either as "drilling funds," which engage primarily in drilling operations, usually on properties where the presence of oil and/or gas reserves has already been proven (so-called developmental drilling funds), or as "income funds," which engage primarily in the acquisition, ownership and sale of production from existing, producing oil and gas reserves. Over the years, the magnitude of oil and gas partnership fundraising has varied in part with market expectations and supply/demand fundamentals in oil and gas markets.

  The IPA also anticipates that the market will soon see the introduction and significant growth of direct participation programs in the alternative energy sector over the coming years as companies engaged in alternative energy development (e.g., solar, wind, biomass, etc.) seek new sources of capital and potentially bifurcate their business model to segregate the more speculative "developmental" aspects of their businesses from the more stable cash flows and income resulting from the sale of the energy they create (akin to the differentiation of drilling funds and income funds in the oil and gas arena).

- Public, Non-listed Equipment Leasing Partnerships ("NL ELPs"). These products provide individual investors with the opportunity to own interests in partnerships or limited liability companies which own assets integral to the operation of a variety of businesses, and to receive cash distributions from the revenue streams generated through the leasing of these assets to those businesses which are typically creditworthy corporate users.

The types of equipment owned and leased by NL ELPs can range from low-tech equipment (e.g., cargo containers, etc.) to high tech equipment (e.g., computers, medical equipment, etc.). The industries served by ELPs include agriculture, healthcare, manufacturing, IT, transportation, and energy/environmental, among others.

- Public, Non-Listed Impact Funds ("NL IFs"). This product is demonstrative of the dynamic nature of the Public Products in that impact investing is a new type of Direct Participation Program and an emerging segment of what can be called socially conscious investing. In a 2010 report, J.P. Morgan Global Research and the Rockefeller Foundation called impact investing "an emerging alternative asset class."

  This product is designed to provide individual investors with stable current income generated by the income received from providing financing, typically through private debt instruments, to small and medium size businesses in the United States and developing economies around the world. The objective of impact investing and this type of Public Product is to generate competitive financial returns and recurring current income for investors while creating a positive economic, social, and environmental impact which is measurable using metrics embodied in the Impact Reporting and Investment Standards (IRIS) and which is reported to investors. Such impacts can include increased employment, increased GDP in the relevant economy, improved environmental or employment conditions, and other positive social changes.

NL Energy Partnerships, NL ELPs and NL IFs represent examples of Direct Participation Programs which have current registered offerings (such Direct Participation Programs are referred to herein collectively as "Other DPPs").

IV. Regulation of Public Products

A. Existing Regulation of NL BDCs

Business development companies ("BDCs"), including exchange-traded BDCs and NL BDCs, are a category of investment company regulated under the 1940 Act that was created by Congress through the enactment of the U.S. Small Business Investment Incentive Act of 1980 (the "1980 Amendments") to facilitate the flow of capital to private U.S. companies and small public U.S. companies that do not have efficient or cost-effective access to public capital markets or other conventional forms of corporate financing.[12]

BDCs are closed-end investment companies that elect to be regulated as BDCs under the 1940 Act.[13] As such, BDCs are subject to significant regulation under the 1940 Act, the U.S. Securities Act of 1933 (the "1933 Act"),[14] and the U.S. Securities Exchange Act of 1934 (the "1934 Act").[15] Entities which externally manage BDCs are subject to the U.S. Investment Advisers Act of 1940 (the "Advisers Act"), which includes a statutory fiduciary duty. Under the 1940 Act, as modified by the 1980 Amendments, BDCs are subject to regulations governing, among other things, portfolio composition, director qualifications and independence, limitations on transactions with affiliates, bonding, capital structure, the approval of underwriting and advisory agreements, and distributions to investors.[16] For example, an NL BDC's use of leverage (debt financing) is limited by the 1940 Act to not more than 50% of its total assets.[17] In addition, a BDC may qualify to elect to be taxed as a regulated investment company ("RIC") for federal income tax purposes, which imposes minimum portfolio diversification standards. As a RIC, a BDC receives preferential tax treatment so long as it distributes 90% of its annual income to investors.

To qualify as a BDC, a company is required to invest at least 70% of its total assets in securities of "eligible portfolio companies," which generally includes the debt or equity securities of private U.S. companies or public U.S. companies that have a public market capitalization of less than $250 million.[18] In order to count portfolio securities as "qualifying assets"[19] for the purposes of the 70% basket test, a BDC must also either control the issuer of the securities or offer to make available to the issuer of the securities significant managerial assistance. Because of the social utility of BDCs in providing increased capital to smaller and private U.S. operating companies, BDCs are provided

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12 *See* Pub. L. No. 96-477, 94 Stat. 2275 (1980); *see also* S. Rep. No. 958, 96th Cong., 2d Sess. 5 (1980); H.R. Rep. No. 1341, 96th Cong., 2d Sess. 21 (1980).

13 *See, e.g.*, Section 54(a) of the 1940 Act.

14 *See, e.g.*, the 1933 Act, available at: http://www.sec.gov/about/laws/sa33.pdf.

15 *See, e.g.*, the 1934 Act, available at: http://www.sec.gov/about/laws/sea34.pdf.

16 *See, e.g.*, Section 57 of the 1940 Act.

17 Section 61(a)(1) of the 1940 Act.

18 Section 2(a)(46) of the 1940 Act and Rule 2a-46 under the 1940 Act (amending the definition of an "eligible portfolio company"), available at: http://www.sec.gov/rules/final/2008/ic-28266.pdf.

19 Under the 1940 Act, a BDC may not acquire any asset other than assets of the type listed in Section 55(a) of the 1940 Act ("qualifying assets"), unless, at the time the acquisition is made, qualifying assets (not including certain assets specified in the 1940 Act) represent at least 70% of the company's total assets.

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additional tools under the 1940 Act in such areas as dealing with their portfolio companies and issuing securities, among other things.

Apart from the 1940 Act, BDCs, including NL BDCs, are subject to additional regulations. For example, BDCs must file with the SEC and make publicly available detailed periodic and current reports, such as Forms 10-Q, 10-K, and 8-K, as well as proxy statements pursuant to the 1934 Act. A BDC must also value its portfolio assets on a quarterly basis, based on "a good-faith estimate of the fair market value using a consistently applied process."[20] Unlike registered investment companies, BDCs must comply with the corporate governance and other provisions of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act").[21]

In addition to federal regulations affecting all BDCs, NL BDCs are required to register with the state securities commissions or divisions of each of the states in which the BDC publicly offers its shares.[22] Although regulations may vary from state to state, many states apply the NASAA Omnibus Guidelines to their review of NL BDCs. NASAA's Omnibus Guidelines[23] address, among other things: NL BDC sponsor financial condition, [24] the reasonableness of fees paid to the External Management and BDC expenses, conflicts of interest, investment restrictions, and BDC investor voting

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20 Peter M. Fass & Derek A. Wittner, *Securities Law Handbook Series: Blue Sky Practice For Public and Private Direct Participation Offerings* § 12.2 (2013); the valuation method prescribed follows the framework for deriving the fair value of assets as set forth by the Financial Accounting Standards Board, Topic 820 (ASC 820), available at: http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820271238&blobheader=application%2Fpdf.

21 Sarbanes-Oxley Act of 2002, available at: http://www.sec.gov/about/laws/soa2002.pdf.

22 The U.S. National Securities Markets Improvement Act of 1996 ("NSMIA") exempted from state "blue sky" laws every "covered security." Congress, in adopting the NSMIA, sought to allocate regulatory responsibility between the federal and state governments based on the nature of the securities offering. *See, e.g.*, NSMIA, available at: http://www.gpo.gov/fdsys/pkg/PLAW-104publ290/pdf/PLAW-104publ290.pdf. Since offerings of the Public Products are not "covered securities" as defined by Section 18 of the 1933 Act, the offerings must be registered in all states in which sales of interests are made. *See, e.g.*, NASAA's Omnibus Guidelines, Statement of Policy on Real Estate Investment Trusts, Statement of Policy Regarding Oil and Gas Programs; and Statement of Policy Regarding Equipment Leasing Programs (further discussing state guidelines on the offerings of products, like the Public Products).

23 NASAA has not yet developed specific guidelines for NL BDCs. However, NL BDCs are subject to NASAA's Omnibus Guidelines, available at: http://www.nasaa.org/wp-content/uploads/2011/07/f-Omnibus_Guidelines.pdf.

24 For a detailed discussion of the different factors related to the computation of the sponsor's required net worth, see the NASAA Omnibus Guidelines, at Section II.B.

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rights. An NL BDC's directors, sponsor, and External Management[25] (as defined below) are deemed to be fiduciaries under the NASAA Guidelines and are responsible for the custody and use of all of the BDC's funds and investments.[26] As such, the External Management must be qualified, with personnel having not less than three years of relevant experience in managing and acquiring the types of assets in which the NL BDC intends to invest. In addition, NL BDCs are limited as to the indemnification from losses or liability which can be provided to the External Management of the NL BDC and to the directors or trustees of the BDC. As discussed in Section V, the distribution of Public Products, including NL BDCs, is regulated by FINRA.

<u>IMPORTANT NOTE</u>: *The term "advisor" in the context of an NL BDC or NL REIT refers to the entity which manages and guides the daily operation of the NL REIT or NL BDC. This entity is typically a company that specializes in the asset class in which the NL BDC or NL REIT invests and is compensated for its services by the NL BDC or NL REIT as described herein. This manager of the entity should not be confused with the client-facing "financial advisor" who deals directly with the investor and provides information and makes recommendations with respect to investments. For purposes of clarity, the IPA will refer to the managers of NL BDC or NL REIT entities as the "External Management" herein.*

Furthermore, NL BDCs must observe investor suitability standards and income and net worth requirements[27] which are imposed by each state's securities regulator.[28] Along with such suitability, income, and net worth standards, the NL BDC is required to

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25 The NASAA Omnibus Guidelines use the term "sponsor"; however, certain functions of the sponsor are the same as those of an investment adviser. In addition, any person or entity providing investment advice to a BDC is required to be registered with the SEC under the Advisers Acts.

26 The sponsor cannot contract away the fiduciary duty owed to the NL BDC or its investors. *See e.g.*, NASAA Omnibus Guidelines, at Section II.D. As an investment adviser registered with the SEC under the Advisers Act, the BDC investment adviser is also required by Rule 206(4)-2 of the Advisers Act to maintain the BDC's funds and securities with a "qualified custodian" (which includes most regulated banks and savings associations, and registered broker-dealers), and to provide notice to the BDC and its stockholders of the qualified custodian's name, address, and the manner in which the funds or securities are maintained.

27 *Id.* at Section III.B. The NASAA Omnibus Guidelines set the minimum net worth requirements for investors at: "(a) a minimum annual gross income of $70,000 and a minimum net worth of $70,000; or (b) a minimum net worth of $250,000" (net worth is determined exclusive of home, home furnishings, and automobile owned). Many states set higher suitability thresholds and also impose "concentration limits" on the percentage of an investor's liquid net worth which can be invested in any one issuer, in any single category of investment (*e.g.*, real estate), or in any investments sponsored by the same management company.

28 *Id.*

disclose in its prospectus its investment objectives and a description of the type of investor that may benefit from its investments.[29] The prospectus must also include tabular disclosure of all consideration that may be received, directly or indirectly, by the NL BDC's External Management and broker-dealers selling shares of the NL BDC to the public.[30] In addition, an NL BDC is subject to extensive affiliated transaction prohibitions, including a prohibition of any sales or leases from the investment adviser or sponsor to the BDC unless the transaction occurs at the formation of the BDC and is fully disclosed in the prospectus, and is determined by an independent expert to be fair to the BDC.[31] An NL BDC must also provide annual reports, consistent with the reporting requirements of the SEC's Form 10-K, as noted above.[32] Unlike many of the products currently proposed for the Department's Asset list, approximately forty states require NL BDCs to pass "merit reviews" which involve inquiry and subjective determinations by the state as to the fundamental fairness of the offering to the investors in that state. Merit state regulators have the authority to refuse to declare the securities registration effective in their state if, in the administrator's view, the offering is deemed to be "unfair, unjust or inequitable." Finally, both an NL BDC and its External Management are subject to periodic SEC examinations to determine compliance with the 1940 Act and Advisers Act, respectively, and under which the SEC is empowered to bring enforcement proceedings for any actions or omissions that it determines to be violations thereunder.[33]

Taken together, NL BDCs' regulation under the 1933 Act, the 1934 Act, the 1940 Act, the Advisers Act and the rules and regulations promulgated thereunder, state securities acts and rules and regulations promulgated thereunder, NASAA Guidelines, state corporation laws, FINRA rules, and select provisions of the Internal Revenue Code and Sarbanes-Oxley Act of 2002 make NL BDCs a highly transparent and regulated product and quite possibly more heavily regulated than many, if not all, of the investments currently included in the Department's proposed Asset List.

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29 *Id.* at Section III.B. The NASAA Omnibus Guidelines also require that the broker-dealer determine that each investor appropriately meets such suitability requirements. *See* the NASAA Omnibus Guidelines at Section III.C (discussing suitability requirements imposed upon broker-dealers).

30 *Id.* at Section IV.A and B. The NASAA Omnibus Guidelines also limit the total distribution costs and organizational and offering expenses paid in connection with an NL BDC's formation.

31 *Id.* at Section V.A and B. *See generally*, Section V discussing additional safety measures to prevent potential conflicts of interest in transaction involving the sponsor its affiliates. In addition, as an "affiliate" of the BDC under Section 17 of the 1940 Act, the BDC's investment adviser is subject to prohibitions on transactions between it and BDC that go beyond the extensive prohibitions under the NASAA Omnibus Guidelines.

32 *Id.* at Section VI.C.

33 *See* Section 42 of the 1940 Act and Section 209 of the Advisers Act.

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B. Existing Regulation of NL REITs

REITs, including traded REITs and NL REITs, are a category of investment vehicles created by Congress through the enactment of the Real Estate Investment Trust Act.[34] REITs were created to provide to all investors access to the benefits of commercial real estate investment, which benefits previously were available only to wealthy individuals or to large institutional investors. Offers and sales of interests in NL REITs are registered under the 1933 Act and with the state securities regulators of each state in which the NL REIT publicly offers its shares. In addition, NL REITs must file with the SEC (and make publicly available) frequent, detailed periodic and current reports, such as Forms 10-Q, 10-K and 8-K, as well as proxy statements pursuant to the 1934 Act. NL REITs that invest primarily in real property are not investment companies. NL REITs that invest primarily in mortgage loans or other real estate-related securities operate pursuant to an exclusion from being deemed an "investment company" under the 1940 Act. The entity which serves as the External Management to the NL REIT is typically a professional real estate management company which may be registered as an "investment adviser" under the Advisers Act.

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

In addition to federal regulations, NL REITs are subject to state specific regulations. Although regulations may vary from state-to-state, many states apply the NASAA REIT Guidelines[35] to their review of NL REITs such that all NL REIT offerings must be accompanied by a detailed prospectus and comply with numerous other requirements. NASAA's REIT Guidelines address, among other things: the qualifications of the NL REIT sponsor, External Management, and independent directors, the reasonableness of fees and expenses, conflicts of interest, investment restrictions, and

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34 The Real Estate Investment Trust Act was included within the Cigar Excise Tax Extension of 1960, to amend section 5701 of the Internal Revenue Code of 1954 with respect to the excise tax upon cigars, and for other purposes. *See* 86 Pub. L. No. 86-779, 74 Stat. 998 (1960). For additional discussion of this point *see* https://www.reit.com/investing/reit-basics/history-reits (discussing the history of REITs and citing the Real Estate Investment Trust Act of 1960).

35 *See e.g.*, NASAA's Statement of Policy Regarding Real Estate Investment Trusts; available at: http://www.nasaa.org/wp-content/uploads/2011/07/g-REITS.pdf).

disclosures. NL REIT directors and the External Management [36] are fiduciaries, and the External Management is responsible for the custody and use of all of the NL REIT's funds and investments. In addition, NL REITs must have independent directors which constitute a majority of the board of directors.[37] Each of the members of the NL REIT's board of directors must be qualified, having not less than three years of relevant experience demonstrating the knowledge and experience required to successfully manage and acquire the types of assets in which the NL REIT intends to invest and must meet certain financial requirements.[38] The NL REIT directors are charged with the fiduciary duty of supervising the relationship of the NL REIT with the External Management, and must establish specific requirements for, and shall require the approval of at least a majority of the independent directors on, all matters applicable to investment policies, reports and meetings, the contract with the External Management and its performance and compensation provisions, fees and expenses, borrowings, and indemnification, among others.[39] In addition, under the NASAA REIT Guidelines, NL REITs are limited as to the indemnification from losses or liability which can be provided to the sponsor or the manager of the NL REIT. The directors, as well as the External Management, are deemed fiduciaries to the NL REIT's investors and that fact is required to be clearly stated in the NL REIT's prospectus.[40]

NL REITs are required to establish minimum investor suitability standards, including income and net worth requirements and concentration limits[41], which are

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36 *Id.* at Section I.B.4. NASAA defines an NL REIT's investment adviser (referred to herein as External Management to avoid confusion with the individual investor-facing "advisor") as "the person responsible for directing or performing the day-to-day business affairs of an NL REIT, including a person to which an adviser subcontracts substantially all such functions." In this regard, "person" typically means an experienced asset management entity.

37 *Id.* at Section I.B.14. NASAA defines an independent director (or, in the context of an NL REIT that is in the form of a trust, an independent trustee) as: persons "who are not associated and have not been associated within the last two years, directly or indirectly, with the sponsor or advisor of the NL REIT." *See, e.g.* Section I.B.14(a) for a complete discussion of the determination of whether a director or trustee is deemed associated, thus not an independent director or trustee.

38 For a detailed discussion of the different factors related to computing the sponsor's capital requirements, *see, e.g.*, NASAA REIT Guidelines, Section II.A.

39 *Id.* at Section II.D and E.

40 *Id.* at Section II.D.

41 *Id.* at Section III.B. The NASAA REIT Guidelines set the minimum net worth requirements for investors at: "(a) a minimum annual gross income of $70,000 and a minimum net worth of $70,000; or (b) a minimum net worth of $250,000" (net worth is determined exclusive of home, home furnishings, and automobiles). Many states set higher suitability thresholds and also impose so-called "concentration limits" on the percentage of an investor's liquid net worth which can be invested in any one issuer, in any single

subject to review by the relevant state securities regulators.[42] Along with such suitability, income and net worth standards, and concentration limits, the sponsor is required to disclose in the NL REIT's prospectus, among others things: (a) a statement of the NL REIT's investment policy (including the types and geographic locations of planned investments in real estate); (b) a description of its method for financing acquisitions; and (c) information about the properties it owns.[43] The prospectus must also include a breakdown of all fees and expenses, all of which must be reasonable and itemized.[44] Fees and expenses are subject to caps and annual review for reasonableness by the independent directors.[45] The NL REIT must also disclose if it will be leasing or purchasing any assets from the sponsor or the External Management. A REIT must also provide annual reports, consistent with the reporting requirements of the SEC's Form 10-K, as noted above.[46] Aside from regular reporting and disclosure requirements, the NASAA REIT Guidelines also require that an NL REIT's formation document[47] include provisions addressing matters such as restrictions on investments and fiduciary duties of directors and External Management, among others.[48]

Finally, unlike many of the products currently proposed for the Department's Asset list, approximately forty states require NL REITs to pass "merit reviews" which involve inquiry and subjective determinations by the state as to the fairness of the offering to investors in that state. Merit state regulators have the authority to deny securities registration and sale in their state if, in the administrator's view, the offering is deemed to be "unfair, unjust or inequitable."

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category of investment (e.g. real estate), or in any investments sponsored by the same management company.

42 *Id.* at Section III.

43 *Id.* at Section II.A and B. The NASAA REIT Guidelines also require that the broker-dealer determine that each investor appropriately meets such suitability requirements. *See, e.g.*, the NASAA REIT Guidelines, at Section II.C (discussing suitability requirements imposed upon broker-dealers).

44 *Id.* at Section IV. The NASAA REIT Guidelines also limit the distribution costs and organization and offering expenses paid in connection with an NL REIT's formation or the syndication of its shares, require the independent directors to determine at least annually whether compensation paid to the investment adviser is reasonable, and provide that the NL REIT's annual total operating expenses shall be deemed excessive if they exceed the greater of 2% of its average invested assets or 25% of that year's net income.

45 *Id.*

46 *Id.* at Section VI.C.

47 For these purposes, "formation document" refers to the document which was used to form or organize a REIT and may be its by-laws, charter, articles of incorporation, declaration of trust or other governing document.

48 For a complete listing of all of the provisions required by the NASAA REIT Guidelines to be included in an NL REIT's formation documents, see Section VIII.A. of the NASAA REIT Guidelines.

Taken together, NL REITs' regulation under the 1933 Act, the 1934 Act, and the rules and regulations promulgated thereunder, state securities acts and rules and regulations promulgated thereunder, NASAA REIT Guidelines, and state corporation laws, FINRA rules, and select provisions of the Internal Revenue Code and Sarbanes-Oxley Act of 2002 make NL REITs a highly transparent and regulated product and quite possibly more heavily regulated that many, if not all, of the investments currently included in the Department's proposed Asset List.

C. Existing Regulation of Other DPPs

Offers and sales of interests in Other DPPs are registered under the 1933 Act and must also be registered under and comply with state securities regulations. Similar to NL REITs, NASAA has issued statements of policy for Oil & Gas Partnerships and Equipment Leasing Partnerships and applies its Omnibus Guidelines to other types of Direct Participation Program securities offered in the states. (Please see footnotes 23 through 32 under the foregoing discussion of "Existing Regulation of NL BDCs" for information concerning the provisions of the Omnibus Guidelines.) These guidelines regulate, among other things: the experience, qualifications and financial resources of management of the partnership, limitations on the level of management fees and expenses, protections to mitigate or eliminate conflicts of interest, investment restrictions, and disclosures. Investors in Other DPPs must meet minimum suitability standards relating, among other things, to income and net worth and concentration limits which are subject to review by each relevant state's securities regulator, including the aforementioned "merit reviews" by approximately forty states. As publicly registered securities, Other DPPs are offered via registration statements which are filed with the SEC and FINRA as well as state securities regulators and must file the required periodic and current reports with the SEC on Forms 8-K, 10-Q and 10-K.

V. Distribution of Public Products

A. The Process of Public Product Distribution

Public Products are distributed through broker-dealers that are registered by the SEC, FINRA and the relevant state securities regulatory authorities. The broker-dealer personnel involved in sales activities ("registered representatives") are also regulated by the SEC, FINRA and the applicable state regulatory authorities.[49] The process of distribution of Public Product securities involves the formation of a selling group of registered broker-dealers. Such selling groups can include more than 200 broker-dealers for large offerings. Unlike initial public offerings for exchange-traded securities, Public Products typically conduct continuous offerings of securities over a two-year period before closing the offering to new investors. The selling group is formed by a dealer manager which is a registered broker-dealer. As described below, each participating broker-dealer must conduct due diligence on the offering and an in-depth suitability analysis for all Public Product offerings. Due diligence investigations for Public Products are typically conducted by independent third parties highly qualified and experienced in the review of Public Products. Direct investor contact occurs between the registered representatives of these participating broker dealers and their clients and not at the dealer manager level.

Fees charged by broker-dealers relating to the distribution of Public Product securities are generally one-time, up-front fees payable out of the Public Product's gross offering proceeds. These front-end fees include sales commissions, dealer manager fees, and bona fide due diligence expenses, the total of which is limited by FINRA to 10% of the gross offering proceeds. When viewed from the perspective of the underwriting costs associated with initial public offerings ("IPOs") of exchange-traded securities (e.g., in a 2013 study conducted by the Lusk Center for Real Estate at the University of Southern California, total offering and organizational costs for exchanged-traded REITs averaged 8.4% compared with 10.9% for NL REITs)[50] and the fact that these up-front fees in Public Products are intended to defray the ongoing services of the broker-dealer and its registered representative during the five to ten year life of the Public Product investment, these fees compare favorably with the annual fees paid by investors to investment advisors based on assets under management for a portfolio including only Assets over a comparable multi-year holding period.

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49 Broker-dealers registering with the SEC must: (a) file SEC Form BD; (b) become a member of a self-regulation organization (usually FINRA); (c) become a member of the Securities Investor Protection Corporation; (d) comply with all applicable state requirements; and (e) any "associated person" (*i.e.*, any partner, officer, director, branch manager, or employee of the broker-dealer) must satisfy applicable qualification requirements, including passing any required exams and participating in continuing education. *See, e.g.*, the SEC Guide to Broker-Dealer Registration; Registration and Regulation of Brokers and Dealers, Section 15 of the 1934 Act; available at: http://www.sec.gov/divisions/marketreg/bdguide.htm.

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

It is noteworthy that Public Products are undergoing an evolution similar to what transpired years ago in the mutual fund industry wherein up-front costs are declining. Enabled by rulings by the Internal Revenue Service which permit multi-share class REITs and motivated by the increased transparency of up-front distribution costs which will result from recent amendments by FINRA to its account statement rules (discussed below), NL REITs are increasingly offering a second share class with a significantly lower up-front distribution cost and trailing shareholder servicing fees which are paid from the earnings of the NL REIT. Among Public Products which offer such share classes, the up-front cost ranges as low as 3.2% with trailing fees of 80 to 100 basis points. Unlike the cumulative fees which can be paid to advisors for recommending many of the Assets on the Department's proposed list, Public Products are restricted by the aforementioned overall FINRA limitation on total distribution costs as to how long advisors can be paid such trailing fees.

Finally, it is also noteworthy that such a significant structural evolution which benefits retail and retirement investors would be discouraged within a regulatory framework which called for a static Asset List.

B. Federal and State Regulation of Public Product Sales Protect Investors and Require Consideration of the Investor's Best Interest

Broker-dealers, whether registered or not, are subject to federal and state securities regulations that are designed to protect investors from fraudulent or deceptive sales of securities.[51]

In addition, broker-dealers who advise investors with respect to Public Products are subject to guidelines adopted by NASAA setting forth high standards of honest and ethical conduct of broker-dealers.[52] Such guidelines require, among other things, that

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51 For instance, Rule 10b-5 under the 1934 Act, states in part: "It shall be unlawful for any person . . . (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." *See, e.g.*, Employment of Manipulative and Deceptive Devices, Rule 10b-5 (17 CFR 240, 10b-5) under the 1934 Act, available at: http://www.ecfr.gov/cgi-bin/text-idx?SID=552e7ef9c5c468e8332fd1b21dbe884c&mc=true&node=se17.4.240_110b_65&rgn=div8.

52 *See, e.g.*, NASAA policy statements on "Dishonest or Unethical Business Practices of Broker-Dealers and Agents" and supplement "Dishonest or Unethical Business Practices by Broker-Dealers and Agents in Connection with Investment Company Shares," available at: http://www.nasaa.org/wp-

broker-dealers: provide investors with a timely disclosure document during the offering period (*e.g.*, a prospectus), charge investors reasonable fees for services provided, and provide written disclosure of any affiliation or common control with the issuer of any security before entering into any transaction. FINRA imposes rules on broker-dealers that require them to conduct due diligence on the products they offer, provide full disclosure, provide fair and balanced communications, and assess the suitability of the products they offer, when dealing with investors. A broker-dealer's failure to comply with any of the foregoing may result in disciplinary actions, fines, and enforcement referrals to the SEC for the each violation.[53]

Federal law and FINRA rules require brokers to "adhere to high standards of conduct in their interactions with investors."[54] As a general matter, the suitability requirements of FINRA Rule 2111 and the FINRA Rule 2310(b)(2)[55] mandate that broker-dealers have a reasonable basis to believe that a recommended transaction or investment involving securities is suitable for each customer based on reasonable diligence[56] into the investor's investment profile. Broker-dealers must believe that the customer has the financial ability to meet the commitment of the investment. The suitability obligation requires that broker-dealers make an assessment of: (1) reasonable basis suitability; (2) customer-specific suitability; and (3) quantitative suitability.[57]

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

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content/uploads/2011/07/4-Dishonest_Practices_of_BD_or_Agent.83.pdf and http://www.nasaa.org/wp-content/uploads/2011/07/35-Dishonest_Practices.pdf.

53 See, e.g., FINRA Sanctions Guidelines, available at: http://www.finra.org/sites/default/files/Sanctions_Guidelines.pdf.

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

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

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

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

employees participating in a transaction) with an understanding of the potential risks and rewards associated with the recommended security or transaction.

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

Quantitative suitability means the broker-dealers with actual or de facto control over a customer account must have a reasonable basis for believing that a series of recommended transactions (even if individually suitable) are not excessive or unsuitable in the aggregate in light of the customer's investment profile. FINRA enumerates several factors that might suggest excessive activity, such as turnover rate, cost-equity ratio, and the use of in-and-out trading in a customer's account.[58]

To further protect Public Product investors, state "blue sky" laws impose their own suitability requirements. Many states model a broker-dealer's responsibility for determining and affirming the suitability of a product after the NASAA Guidelines, which include: (1) a product-specific determination as to whether an investor reasonably meets the product-specific net worth and income minimums; (2) evaluating the extent to which an investor would benefit from the product if its investment objectives were met; (3) evaluating the investor's ability to tolerate the product's risks; (4) assessing whether the product's expected liquidity is suitable for the investor; and (5) maintaining records of how reasonable investor suitability was determined.[59]

Furthermore, several states impose stricter suitability limitations on an investor's ability to purchase Public Products.[60] These states "require either a diversification standard that the investment cannot exceed 10% of the purchaser's liquid net worth or impose a net worth test that provides that the investor's net worth must be at least 10 times their investment" amount in these products.[61] Thus, at the state level, investor safeguards are designed to ensure that investors are purchasing only products that are suited for them and are protected from investing more than they should in these products.

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

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

60 Peter M. Fass & Derek A. Wittner, *Securities Law Handbook Series: Blue Sky Practice For Public and Private Direct Participation Offerings* § 2.2 (2013) (stating the states that impose limitations that are stricter than the NASAA requirements are: California, Iowa, Kansas, Kentucky, Maine, Massachusetts, Michigan, Missouri, Nebraska, Ohio, Oregon, Pennsylvania, and Tennessee).

61 *Id.*

C. Broker-dealers Offering Public Products are Subject to Additional Disclosure Requirements and Investor Safeguards

Broker-dealers offering products, such as the Public Products, are subject to additional product-specific disclosure requirements pursuant to FINRA Rule 2310. Prior to investing, Section (b)(3) of the Rule requires "that all material facts are adequately and accurately disclosed [to offerees] and provide a basis for evaluating the program."[62] In determining the adequacy of disclosure, FINRA sets minimum guidelines for broker-dealers, such as requirements for disclosure of: "(i) items of compensation; (ii) physical properties; (iii) tax aspects; (iv) financial stability and experience of the sponsor; (v) the program's conflicts and risk factors; and (vi) appraisals and other pertinent reports".[63] In dealing with conflicts of interest, the SEC takes the position that a broker-dealer's duty of fair dealing falls within the above-mentioned suitability obligation, which generally requires a broker-dealer to make recommendations that are consistent with the interests of its customers. Broker-dealers, when making a recommendation, must disclose material conflicts of interest to their customers.[64] Also, the federal securities laws and FINRA rules restrict broker-dealers from participating in certain transactions that may present particularly acute potential conflicts of interest.[65] Moreover, broker-dealers who fail to adequately disclose conflicts of interest may be subject to the SEC's "remedial sanctions such as censures, suspensions, injunctions and limitations on business, and violators may be required to pay disgorgement and civil penalties."[66]

In addition, Section (b)(4) of Rule 2310 imposes a fair and reasonableness standard upon the organizational and offering expenses, which together with aggregate underwriting compensation may not exceed 15% of the gross proceeds of the offering.[67] In practice, the total combined underwriting compensation and organizational and offering expenses typically do not exceed between 11% and 12.5% for Public Programs.

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

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

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

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

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

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

As previously observed, this limit reflects the aggregate (and highly transparent) charge for advisory services which extend over the five to ten year life of the Public Product and therefore compare favorably to many investments on the Department's proposed Asset List for which advisory fees may be charged over indeterminately long periods, and for which such fees can and do exceed the percentage typically incurred by Public Programs. As such, Public Programs have an added protection of a lifetime cap which does not exist in other forms of compensation for other securities. Pursuant to disclosure requirements associated with registration under the 1933 Act, such fee structures are fully disclosed within each product's registration statement.

Moreover, recent amendments to FINRA Rule 2310 and NASD Rule 2340[68] will, once effective in April 2016, impose additional transparency requirements on Public Products.[69] These rules prohibit broker-dealers from participating in a public offering of Public Products unless the issuer has agreed to disclose a per-share estimated value in its periodic report that has been developed in a manner reasonably designed to ensure its reliability.[70] The amended rules will also require that customer account statements provide the investment's estimated value, net of up-front fees. In addition, broker-dealers are required to show the methods used for determining the estimated per-share value on a customer account statement, with the use of an independent third-party valuation expert and industry standard valuation methodologies required to obtain accurate valuations after closing of the initial offering.[71] The primary focus of the rules is to increase the transparency of the costs associated with broker-dealer distributed products and improve the "price discovery" and reliability of valuations on customer account statements. Ultimately, these enhanced disclosures will provide more meaningful information to investors, particularly with respect to understanding the cost of brokerage services and

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

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

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

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

the value of their investments, and will exert downward pressure on distribution costs. Broker-dealers selling interests in NL BDCs are required by the SEC to publish their current net asset value (NAV) on a regular basis (*i.e.*, in reports that are publicly disclosed not less than quarterly).[72] As described elsewhere herein, the valuation of NL BDC securities is governed by strict requirements of the 1940 Act. In addition, the SEC imposes disclosure requirements in connection with the offering of NL REITs, including disclosures with respect to distributions, dilution, redemptions, NAV, and prior performance.[73]

In addition to federally required disclosures, many states follow the NASAA Guidelines[74] and, as discussed above, require that extensive and specific disclosures be made in product offering documents.

In addition to the foregoing, the IPA has adopted standardized guidelines that address both NL BDCs and NL REITs. The NL BDC Performance Guideline incorporates comments and input from FINRA on the calculation and reporting of NL BDC investment performance.[75] The Guideline addresses, among other things, the basis and reporting of performance figures, and the methodology and disclosure of shareholder returns and NAV.[76] The IPA Practice Guideline on Valuations of Publicly Registered Non-Listed REITs, which also incorporated comments and input from FINRA, provides a uniform methodology for valuing NL REITs, guidelines to insure independence and avoid conflicts of interest in the process of determining valuations, and enhancements of the valuation disclosures for investors.[77]

Finally, in addition to fulfilling regulatory requirements, many broker-dealers impose their own internal investor safeguards. Examples include client-level concentration limits linked to specific client profiles, firm-level concentration limits

72 *See, e.g.*, NASD 2340, amended effective April 2016.

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

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

75 See, IPA Non-Listed BDC Performance Guideline, available at: http://www.ipa.com/policy-issues/guidelines.

76 *See, e.g.*, IPA Non-Listed BDC Performance Guideline, available at: http://www.ipa.com/policy-issues/guidelines/.

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

related to certain types of products or asset classes, and mandatory advisor education requirements related to each specific category of Public Program asset focus prior to placing a Public Product with that asset focus with investors.

VI. Public Products are Common for Retail Investors

The Public Products are not only a common investment for retail investors generally, but are also a common investment for IRAs. As of the end of 2014, there was over $66 billion of outstanding equity investment in NL REITs and over $12 billion in NL BDCs.[78] Of these amounts, approximately 41% of the non-listed REIT investments were held by IRAs and approximately 48% of the NL BDC investments were held by IRAs.[79] There are over 2.8 million retail accounts invested in NL BDCs and NL REITs alone.[80] Of these retail accounts, 43%, or over 1.2 million, are IRAs. Over 30,000 advisers currently provide advice for portfolios that invest in either BDCs or NL REITs.[81] (See also statistics cited on page 13 hereof and included in Attachment A.)

The Department has not set a standard for what constitutes a "common" retail investment, but it would seem that a product with millions of accounts and billions of dollars invested should be considered common. If the Department does not revise the definition of "Assets" as currently provided within the Proposed BIC Exemption, it will deprive retirement investors of the opportunity to invest in products which may be particularly favorable for their individual situations.

As previously mentioned, the Public Products are direct investment programs which typically invest in tangible assets such as real estate, equipment leasing, or energy, or as in the case of NL BDCs, invest primarily in loans to certain U.S. businesses.

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78 *See* Attachment A, at page 3.

79 *Id* at pp. 2-3. At our June 4 information meeting with the Department, Messrs. Hauser and Canary and Mmes. Hall and Lloyd asked if we could provide additional information regarding the types of pension investors in each of these products. We have determined that these products would almost certainly not be investment options in an employer-sponsored 401(k) plan, other than through a brokerage window, in large part because for Public Products regulatory agencies impose individual investor suitability requirements which would be next to impossible to apply on a plan-wide basis. We are unaware of any available studies that quantify the number of defined benefit plans that invest in these products, but based on anecdotal evidence from our membership, we believe that a small number of defined benefit plans invest in NL REITs. Of the number of "qualified accounts" invested in Public Products as shown in the attached supplemental data, the vast majority of these qualified accounts are IRAs.

80 *Id.* at p. 6

81 *Id.* at p. 8.

Traditionally, these types of investments are intermediate to long-term with a focus on current income, preservation of capital and potential growth. As non-listed investments, the Public Products typically have less daily volatility than their exchange-listed counterparts, and tend to have a low correlation to other financial asset classes. These features, together with the added diversification Public Products bring to financial asset portfolios, can help to enhance an investor's overall portfolio return while reducing risk. Moreover, the Public Products offer many benefits to investors, including the potential for superior current yields, the potential for competitive total returns, and access to experienced management teams which specialize in the asset class.

The Public Products clearly serve an important purpose in a retirement or other portfolio. As many financial advisors have learned, the investment performance of these Public Products justifies their inclusion in investor portfolios. For example, in the most recent and comprehensive study of performance, the average annual returns for NL REITs outperformed both the S&P 500 and a typical bond fund benchmark.[82] The performance of Public Products also does not correlate directly with the S&P 500, thus providing the type of diversification recommended by Modern Portfolio Theory. Given these attributes and as discussed in more detail below, there seems to be no principled reason why an IRA investor should be denied the ability to choose to invest in NL REITs or NL BDCs, not to mention have the option to invest in Other DPPs, because these investments are not on the Department's Assets List.

VII. Fees and Expenses of Public Products

The fees and expenses associated with Public Product investments can be segregated into two distinct categories: (1) fees and expenses associated with the formation of the Public Product and sale of its securities to the investing public through financial intermediaries (referred to herein as "Offering and Organizational Costs"; and (2) fees and expenses associated with the management and operation of the entity and its assets (referred to herein as "External Management Costs"). The first category of fees and expenses include compensation to the broker-dealers, registered representatives and investment advisers who make investment recommendations to investors. The second category of fees and expenses are paid exclusively to External Management or other third parties and are not related to the process of recommending investments to individual investors.

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82 *Id.* at p. 15.

When evaluating the nature and level of fees and expenses for Public Products, it is important to understand the overall structure of management of the enterprise. For example, NL REITs and NL BDCs, like their exchange-traded counterparts, can be either internally or externally managed. Simply put, internally managed entities are operated by employees of the entity and the overall costs of management, including the salaries, benefits and incentive compensation of these employees, are subsumed into the entity's reported "general and administrative expense" reporting. In contrast, externally managed entities typically have no employees and instead contract with a separate company experienced in the asset class to provide management services and conduct the day-to-day operations of the entity. The costs of such external management are separately reported (typically categorized by the nature of the service provided – e.g., acquisitions, asset management, property management, etc.) in financial statements as fees paid to the contracted management entity. As such, while potentially giving the false impression of higher management costs, externally advised NL REITs and NL BDCs have considerably more transparency than their exchange traded, internally managed counterparts.

Exchange traded REITs and BDCs which are externally managed also differ in important respects from NL REITs and NL BDCs which are externally managed. For example, the management contracts entered into by externally managed exchange traded REITs are not subject to any regulatory limits with respect to the compensation paid to the External Management or the length of the management contract. In contrast, NL REITs are subject to numerous and detailed NASAA Guideline limitations on fees and expense reimbursements which can be charged by the External Management. Unlike their exchange traded counterparts, any incentives paid to the management of an NL REIT must be subordinated to a full return of the investor's capital and a minimum average annual return to the investor – a very significant investor protection which exchange traded REITs (which are on the Department's proposed Asset list) do not have. NASAA Guidelines also impose requirements that the management contracts must be reviewed annually by the independent directors and must be cancellable without cause and without penalty on sixty days prior notice. These regulatory rules provide an added level of investor protections designed to insure reasonable and competitive pricing for specific services rendered.

The determination of which management structure, internal or external, to use is made initially by the issuer, and is reviewed and decided upon by the independent directors. Since Public Products commence their existence as initial public offerings which have not yet raised capital nor made investments, external management structures are preferred in that they avoid the challenge of attempting to attract an experienced management team and incur the associated full overhead expenses for a company which has not yet raised capital, acquired a portfolio, or generated revenues over which to spread such employment costs.

Below is a description of the fees and expenses to which Public Products are typically subject. It is important to keep in mind that, as discussed in Parts IV and V of this letter, unlike many of the products on the Department's proposed Asset list, the fees and expenses of Public Products are subject to limitations imposed by both federal and state regulations.

A. NL BDCs

Separate and apart from the offering and organizational costs incurred in connection with the formation of the product and the distribution of its shares (*see* Section V), externally-managed NL BDCs are typically charged the following types of fees and expenses: (a) general and administrative expenses associated with the provision of certain services to the BDC by third-parties (*e.g.*, professional fees) and the External Management; (b) a management fee payable to the NL BDC's External Management, which is calculated based on a percentage of the NL BDC's average gross assets; and (c) incentive fees on income, which are typically subject to a hurdle rate of return to investors, and on capital gains.[83] The methodologies for calculating incentive fees vary among NL BDCs.[84] A depiction of an example of the structure of a BDC and the flow of fees and expenses is illustrated on Attachment B.

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83 The Public Products generally provide to those responsible for managing those products compensation that is based on performance, in addition to a fee that is based on a percentage of the assets under management in the vehicle. This form of compensation (which is commonly referred to as a "performance fee") can be calculated in a variety of ways, including as a percentage of realized gains or the increase in value of a vehicle's assets during a specified period, and may be paid as a fee pursuant to a management agreement or as capital gains. The payment of performance fees to registered investment advisers is governed by Section 205 of the U.S. Investment Advisers Act of 1940 and certain of the rules thereunder. For a detailed discussion on the topic of performance fees, see the report of the U.S. Securities and Exchange Commission's Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation, pp. 237-251 (May 1992), available at: www.sec.gov/divisions//investment/guidance/icreg50-92.pdf. For those Public Products that provide for the payment of performance fees, that fact, along with the details of the calculations methodology, is disclosed to the investors in the product's offering documents.

84 In the case of internally-managed BDCs (*i.e.*, BDCs that are managed by their officers and employees), which are far less common, fees and expenses may include: general and administrative expenses (*e.g.*, professional fees, marketing and research expenses, and travel expenses), employee salaries and benefits, and performance-based compensation to officers and employees (*e.g.*, options and restricted stock awards).

B. NL REITs

Separate and apart from the offering and organizational costs incurred in connection with the formation of the product and the distribution of its shares (*see* Section V), there are a variety of fees and expenses charged in connection with the operation of an NL REIT. While not all NL REITs are subject to the same fees and expenses, examples of the types of fees and expenses payable by most NL REITs to the External Management and its affiliates include: acquisition fees for the selection, evaluation, structuring and purchase of real estate assets or acquisition of securities; in the case of mortgage REITs origination fees in connection with the evaluation and structuring of loans; the reimbursement of expenses incurred in connection with the selection, purchase development or construction of properties or the making of loans (often subject to a cap except to the extent waived by the NL REIT's independent directors); an asset management fee based on a percentage of the cost or value of the NL REIT's assets; property management fees, oversight fees, and construction management fees to affiliates of the investment adviser; a financing coordination fee as a percentage of the amount of any original financing or refinancing is coordinated by the External Management; reimbursement of personnel costs for the provision of administrative services to the NL REIT (*e.g.*, facilitation and coordination of transfer agency services, call center activities, and reporting and trouble-shooting activities); disposition fees where substantial services have been provided in connection with the sale of the NL REIT's real property assets; and incentive fees upon the successful completion of a liquidity event typically limited to 15% of investor returns in excess of a full return of investor capital plus an average annual return on investment. As previously described, many of the fees described above as being paid to the manager of an externally managed NL REIT would be paid in the form of compensation, benefits and related overhead to employees of an internally managed NL REIT. A depiction of an example of the structure of an NL REIT and the flow of fees and expenses is illustrated on Attachment B.

C. Other DPPs

The fee structures of Other DPPs parallel those of Public, Non-Listed REITs and BDCs, with a virtually identical distribution process and cost limitations. Other DPPs also typically have an external management structure in the form of a general partner organization and incur fees and expenses specific to the operation of the assets and businesses they conduct. A full recitation of these fees and expenses for the various asset classes and business undertakings of Other DPPs is beyond the scope of this letter but will be provided to the Department upon request.

VIII. Liquidity and Redemption of the Public Products

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

Although these Public Products are clearly marketed as illiquid securities subject to intermediate to long-term holding periods, and are subject to strict suitability requirements (including minimum levels of income and net worth and maximum concentration limits) imposed by the NASAA Guidelines, the states and broker-dealers to insure the financial qualifications of investors, Public Products do allow for early redemption by an investor. While the terms and limitations may vary, it is typical for NL BDCs and NL REITs to offer share repurchase programs to provide investor liquidity in advance of the occurrence of a final liquidity event, such as a stock exchange listing, merger or sale of the assets. These share repurchase programs are limited in that they often are legally required to impose caps on the number of shares to be acquired (e.g., a maximum percentage of the number of shares outstanding). While share redemption programs are typically discretionary on the part of the fund, they have a record of honoring redemption requests under normal economic and capital market conditions.

The vast majority of NL REITs provide liquidity for shareholders that seek it upon exigent circumstances. Shareholder redemption programs offer liquidity through the repurchase of up to 5% of outstanding shares on an annual basis. As previously observed, a recently introduced form of NL REIT that is gaining momentum in equity fundraising, the Daily NAV REIT, will accommodate the redemption of up to 20% of the REIT's NAV each year – indicating an on-going trend toward the provision of greater liquidity among Public Products. NL REIT share repurchase programs typically require a minimum hold of one year except for redemptions upon the death or disability of the investor. While each NL REIT may offer different redemption terms, many provide liquidity through shareholder redemption programs beginning in year 2 at 92.5% of the NAV or offering price, increasing to 95% in year 3 and scaling similarly for the remainder of the holding period. Exceptions exist for death and disability hardship redemptions that pay the shareholder 100% of original investment or NAV regardless of the holding period. NL BDCs typically offer liquidity through the repurchase of up to

10.0% of outstanding shares on an annual basis via quarterly tender offers. Repurchases by NL BDCs are typically made based on the fund's current NAV.

Public Products also seek to provide complete investor liquidity at the end of their terms. For example, Public Products may seek to list their shares on a national securities exchange, effect a merger whereby shareholders would receive cash or listed securities, or effect a sale of all or substantially all of their assets.

The fact that Public Products do not offer the full liquidity associated with exchange-traded securities and mutual funds is not a sufficient reason to exclude them from IRA portfolios, and in fact relates to the reason why they should be included in retirement portfolios. As retirement accounts are generally designed for long-term holding, there is no reason why a less liquid investment would be *per se* improper. In fact, the lack of immediate liquidity discourages "churning" and "market timing" and further reduces volatility and the investment portfolio's correlation to the stock market.

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

Finally, as previously observed, the potential portfolio volatility which, of necessity, accompanies portfolios of directly or indirectly owned exchange-traded securities which, in turn, are subject to the vagaries of the traded markets, can force investors who are taking retirement plan distributions to effectively liquidate their investments at times of depressed market conditions, thereby jeopardizing the future income-generating potential of their retirement savings and compromising their lifestyles.

IX. Discarding the "Legal List"

A. The Department Should Discard the List of "Assets"

A list of "Assets" will deprive investors of choice and will render the Department unable to easily adapt to market changes. New investment products are continually introduced to the market. It is not feasible to expect that the Department will have the means or ability to regularly and continually consider and analyze new investment products for inclusion as an Asset. As a result, the Asset list process will create a category of investors who are not able to take advantage of market evolutions and improvements. Further, this will result in those investors being precluded from seeking the same return available to other investors or from being able to diversify their investment portfolios on the same basis as other investors. This outcome could both lower returns and increase risk through lack of portfolio diversification—the exact opposite of the Department's objectives.

Some of the emerging Public Products and structural changes among existing Public Products demonstrate this precise principle. NL Public Energy Partnerships, for instance, share many of the same qualities as NL REITs, but have not yet captured the same level of market interest. IPA believes that it is only a question of time and that a list of approved Assets would effectively hamper the development of this product. Similarly, NL IFs are an emerging public product. NL REITs have recently introduced multi-share class products which provide optionality to the investor to select a product with significantly lower front-end distribution costs. Given the evolution of various investment products over the past decades, placing artificial restrictions on what options are open to IRA investors seems designed to tamp down market growth and limit options for investors.[85]

In the Proposed BIC Exemption, the Department emphasized that it intended to adopt a "principles-based" or "standards-based" approach that "would flexibly accommodate a wide range of current business practices" while minimizing conflicts of interest.[86] Yet while the Proposed BIC Exemption is designed to accommodate a wide range of compensation, and to be adaptable over time to market changes in the way investment advisers are compensated, the Department abandoned a principles-based approach when it came to the types of assets covered by the exemption. By proposing a fixed list of acceptable "Assets", the Department chose to freeze in time the types of investments that may be offered to retail retirement investors. We urge the Department to reconsider the "legal list" approach, which is inconsistent with the history of ERISA and modern trust law. We urge the Department instead to adopt a flexible, principles-based approach to the types of assets to which the Proposed BIC Exemption applies and to allow retail retirement investors to continue to invest in Public Products.

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85 Any suggestion that this problem could or should be resolved through the individual exemption process is unworkable. If every time a new product evolved, the industry sponsor was required to submit an application for an individual exemption, it would cause enormous administrative burdens on both the Department and the industry.

86 Proposed BIC Exemption, at 21961.

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Until the early 1940's, many states required trustees to select investments from a statutory list of supposedly safe investments (a so-called "legal list"). Painful experience from the Great Depression showed, however, that virtually no investment is immune from risk, and that even the safest bonds and traditional investments could become worthless.[87] Legal lists failed to adapt to changing economic and business conditions, and reflected the since-discredited assumption that past performance is a reliable predictor of risk. As a result, the legal lists tended to prohibit relatively safe investments in companies with an arguably risky past but a stable future, while permitting investment in more risky companies with a stable past but risky future. This history led the drafters of Restatement (Third) of Trusts to conclude that "knowledge, practices, and experience in the modern investment world have demonstrated that arbitrary restrictions on trust investments are unwarranted and often counterproductive."[88]

The modern trend of fiduciary investment principles was driven in part by dissatisfaction with poor investment performance in legal list jurisdictions, and in part by a large body of academic research that resulted in what is known as modern portfolio theory.[89] Modern portfolio theory demonstrates that portfolios of risky (*i.e.*, more volatile) stocks can be combined in such a way that the portfolio as a whole could be less risky than the individual stocks in it.[90]

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87 *See*, *e.g.*, Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, 27 Real Prop. Prob. & Tr. J. 407 (1992) (summary of the background, development and criticism of tradition trust doctrine regarding investments, plus an overview of modern portfolio theory and other modern developments, from the Reporter for the Restatement (Third) of Trusts); H. Bines, *Modern Portfolio Theory and Investment Management Law : Refinement of Legal Doctrine*, 76 Columbia L. Rev. 721 (1976) (describing the disastrous performance of "legal list" portfolios during the Great Depression in comparison to more flexible prudent man jurisdictions).

88 Restatement (Third) of Trusts, Ch. 17, Investment of Trust Funds (Introductory Note, Edward C. Halbach, Jr., Reporter); *See, also*, Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, 27 REAL PROP. PROB. & TR. J. 407 (1992); Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U.L. REV. 52 (1987); B. Longstreth, *Modern Investment Management and the Prudent Man Rule* (1986).

89 *See*, *e.g.*, Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, *supra*; H. Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, *supra*; John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, Yale Law School Faculty Scholarship Series (1976); John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law II*, Yale Law School Faculty Scholarship Series, Part I (1977) (describing the evolution of trust law, evidence for the notion that modern investment theory may be superior to conventional trust investment structures, and has served as evidentiary backing for modern reforms in trust law and the investment duties).

90 A good general discussion of modern portfolio theory can be found in Burton G. Malkiel, *A Random Walk Down Wall Street*, Ch. 8 (9th edition 2007).

ERISA was the first legislation to apply modern portfolio theory to fiduciary standards of investment and has been an influential landmark in the development of modern fiduciary law.[91] The Department can justifiably be proud of the leading role ERISA has played in applying flexible and modern principles to the investment duties of fiduciaries. In this regard, perhaps the most significant development beyond the adoption of ERISA itself was the express reliance on modern portfolio theory in the final regulations under Section 404 of ERISA:

> **[I]**t is the Department's view that an investment reasonably designed—as part of the portfolio—to further the purposes of the plan, and that is made upon appropriate consideration of the surrounding facts and circumstances, should not be deemed to be imprudent merely because the investment, standing alone, would have, for example, a relatively high degree of risk . . . . Accordingly . . . "appropriate consideration" shall include a determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio for which the fiduciary is responsible, to further the purposes of the plan, taking into account the risk of loss and opportunity for gain (or other return) associated with the investment or investment course of action. (footnote omitted).[92]

Most important to the present discussion, the Department emphasized that its approach to prudent investing reflected a conscious decision to depart from legal lists and other traditional, restrictive applications of trust law:

91 *See*, W. Brantley Phillips, Jr., *Chasing Down the Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts*, 54 Wash. & Lee L. Rev. 335 (1997) (describing how the passage of ERISA prompted the modernization effort of the third Restatement and uniform state laws on prudent investment); Samuel D. Cheris, *Making Responsible Investment Decisions in Light of the Prudent Person Rule*, 14 Est. Plan. 338 (1987) (describing how Congress adopted ERISA after hearing extensive testimony to the effect that traditional interpretations of prudence were too restrictive when applied to employee benefit plans).

92 44 Fed. Reg. 31639 (June 1, 1979), reprinted in CCH, Pension and Employee Benefits, Vol. 3, par. 24,038 (2015).

> [T]he Department does not consider it appropriate to include in the regulation any list of investments, classes of investment, or investment techniques that might be permissive under the 'prudence' rule. No such list could be complete; moreover, the Department does not intend to create or suggest a 'legal list' of investments for plan fiduciaries.
>
> The preamble to the proposed regulation stated (as does this preamble) that the risk level of an investment does not alone make the investment *per se* prudent or *per se* imprudent.[93]

The impartial conduct standards embodied in the Proposed BIC Exemption were designed to mirror the ERISA duty of prudence, combined with the duty of loyalty[94]. It would be a mistake (and more than a bit ironic) to require broker-dealers in the retail retirement market to adhere to ERISA's standard of prudence while at the same time preventing them from considering investment products which, under the Department's own prudence regulations, they may be required to take into account in serving the best interests of their customers. Moreover, the Department's list would invariably – and in all likelihood quickly – suffer the same fate as the legal lists of the past, falling behind ever-changing market conditions, failing to adapt to new products and advances in knowledge, and consequently relegating the Proposed BIC Exemption to the margins of the retail marketplace:

> Trust investment law should reflect and accommodate current knowledge and concepts. It should also avoid repeating the mistake of freezing its rules against future learning and developments.[95]

However, the Asset list does exactly the opposite. It explicitly does act to create by regulation a list of investments that are or are not appropriate. The list places the Department in the position of weighing which investments represent a suitable level of

93 *Id.*
94 Proposed BIC Exemption, at 21970.
95 Restatement (Third) of Trusts, Ch. 17, Investment of Trust Funds (Introductory Note, Edward C. Halbach, Jr., Reporter).

risk and which ones do not, as well as dictating the limits by which certain investors can access investment products in order to diversify their portfolios.

Finally, we would like to point out that in the preamble to the Proposed BIC Exemption, the Department said that it expects the best interest standard to be interpreted by courts in light of forty years of judicial experience with ERISA's fiduciary standards.[96] However, if the Department insists on inserting a legal list into the Proposed BIC Exemption, and thereby departing from a core principle of ERISA, it would virtually assure that interpretation of the best interest standard will diverge over time from otherwise applicable ERISA fiduciary standards.

B. If the Department maintains the "legal list" it should add the Public Products to that list.

If the Department determines that a return to the "legal lists" of the past best serves the purposes of the Regulation and the Proposed BIC Exemption, IPA respectfully requests that the Department include the Public Products on that list. As noted above, Public Products are common, indeed ubiquitous, in the retirement investment marketplace and commonly included in many investor portfolios, providing access to investment opportunities once only available to wealthy investors and institutions, as well as diversification and protection against market volatility. To accomplish IPA's request in the most clear manner possible, IPA suggests that the list of "Assets" be amended to include NL REITs and also NL BDCs and Other DPPs as such direct participation programs are defined by FINRA in Rule 2310 and regulated by FINRA."

The other terms and conditions of the Proposed BIC Exemption are already robust and flexible enough to protect retail investors, regardless of the product type. For example, if a recommended investment has different characteristics than "Assets" on the current list – such as less liquidity, lack of a public market, or different fee structure – those characteristics would have to be disclosed and taken into account by the adviser in order to meet ERISA's fiduciary obligations, and the stringent best interest standard and other conditions of the Proposed BIC Exemption. Certainly, not all investments would be in the best interest of all retail investors, but the investment adviser's newly imposed fiduciary status combined with the conditions of the exemption already require the adviser to consider those factors before making a recommendation. Since the conditions of the exemption are both flexible and demanding, the Department need not attempt to

96 *Id.* at 21970.

determine in advance which assets are appropriate to particular retirement investors, or under what circumstances.

Moreover, the definition of "Adviser" in the exemption already requires compliance with applicable federal and state securities laws and licensing requirements with respect to the covered transaction. Thus, for example, any additional disclosure requirements or suitability standards of FINRA or other regulatory authorities with respect to NL REITs, NL BDCs or Other DPPs are effectively incorporated into the Proposed BIC Exemption.[97] Consequently, the exemption is flexible enough to accommodate different types of investment on the "Asset" legal list. At a minimum this should favor the inclusion of Public Products on the legal list.

A comparison of some of the items on the list of "Assets" with the Public Products illustrates some of the deficiencies of relying on a pre-established list of products, as opposed to providing a list of factors (and perhaps some baseline criteria) that industry participants can take into account in deciding for themselves whether a product complies with their fiduciary duties under the Proposed BIC Exemption and Proposed Conflict of Interest Rule. While the Department has expressed some concern about the liquidity of retirement investments, it has nevertheless included products on the legal list which impose penalties if the investor wishes to exit the investment early. Public Products offer share repurchase programs which provide limited liquidity for investors in exigent circumstances and have a record of honoring such redemption requests under normal economic and capital market conditions. To the extent that any of the externally managed Public Products invest in securities, their managers are subject to the fiduciary duties imposed upon investment advisers under the Investment Advisers Act of 1940. In addition, NL BDCs are subject to the strict fiduciary standards imposed by the 1940 Act regardless of whether they are listed (and thereby constitute "Assets" under the proposed rule) or unlisted (as is the case with the NL BDCs that constitute Public Products). Like any of the "Assets" that are sold by a broker-dealer or investment adviser (as defined by the Advisers Act), including corporate bonds, exchange traded funds and interests in registered investment companies, those selling the Public Products are also subject to the basic FINRA imposed suitability and disclosure requirements (in the case of brokers) or the Advisers Act's imposed fiduciary standards (in the case of investment advisers). Despite being illiquid securities, NL BDCs currently have, and NL REITs pursuant to newly adopted regulations will have, regularly determined prices, like the majority of the items on the list of Assets. Any justification or authority the Department has for including some investment products as Assets, while excluding others, such as the Public Products, is far from clear.

97 *See, e.g.*, FINRA Rule 2310, discussed above at Section V.C.

X. Other Suggestions to make Proposed BIC Exemption more workable

A. The Department should reconcile its use of "best interest" with the existing guidance regarding ERISA's fiduciary obligations in order to avoid inconsistent and confusing interpretations.

In the preamble to the Proposed Conflict of Interest Rule, the Department states that the best interest standard "is not intended to add to or expand the ERISA section 404 standards of prudence and loyalty as they apply to the provision of investment advice to ERISA covered plans", but is instead intended to apply existing ERISA standards of prudence and loyalty to the IRA market.[98] Similarly, the preamble to the Proposed BIC Exemption provides that the best interest standard is intended to mirror the ERISA duty of prudence, combined with the duty of loyalty.[99] Yet the language of the best interest standard does not exactly mirror the standards of prudence and loyalty from ERISA section 404. While we understand that the Department believes that its departures from a literal blending of the duties of prudence and loyalty are simply uncontroversial glosses on those duties under existing law, it is not reasonable to expect that the differences in language between ERISA section 404 and the best interest standard will not lead to different meanings in the hands of courts and litigants. Accordingly, if the Department truly intends for the best interest standard to mirror the duties of prudence and loyalty under ERISA, it should do so directly by using the same words, or through a cross reference to the duties of loyalty and prudence under ERISA. Any additional explanatory gloss, such as "based on investment objectives, risk tolerance, financial circumstances and needs" of the investor, and "without regard to the financial or other interests" of the adviser and related parties, should be covered in the preamble or through examples, rather than in the text of the best interest standard itself.

B. The Department should clarify the use of typical revenue sharing payments.

The preamble to the Proposed BIC Exemption states that the Department intends for the exemption to facilitate the continued use of types of fees and compensation common in the retail market, including brokerage commissions, 12b-1 fees and revenue sharing payments. One of the conditions of the exemption is that a financial institution's policies and procedures must not authorize compensation or incentive systems that would

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98 Proposed Conflict of Interest Rule, at 21938.

99 Proposed BIC Exemption, at 21970.

tend to encourage individual advisers to make recommendations that are not in the best interest of retirement investors. The final BIC Exemption should make clear – through safe harbors or examples – that such common forms of compensation, by themselves, do not "tend to encourage" advisers to make recommendations that are not in the best interest of investors or otherwise fail to meet the best interest standard.

C. The Department should re-evaluate the timing of the contract requirement between investor and investment adviser.

We are also concerned that the requirement that the adviser enter into a written contract with the retirement investor *prior to* making a recommendation is impractical. Given the breadth of the concept of a "recommendation" under the Proposed Conflict of Interest Rule, advisers may be unwilling even to talk to a retirement investor without first requiring the potential investor to sign a written contract. Prospective investors may well be intimidated or generally put off by an adviser requiring them to sign a detailed contract at the beginning of their first conversation.

Moreover, the prior-to requirement could encourage some advisers to preface their introductory conversations by stating that they are speaking to the investor only with respect to her non-IRA or non-plan accounts, bringing out the contract only if the investor later says she wants to invest from her IRA. Either way, the prior-to rule leads to unintended results.

We believe that the written contract requirement should be revised to require a written contract prior to the receipt of any compensation to which the Proposed BIC Exemption is intended to apply. In that way, if the contract satisfying the exemption is not in place before the compensation is received, the compensation would not be covered by the exemption. But advisers and potential investors would be free to have preliminary conversations without the need for a written contract. This would also eliminate any confusion about when the adviser is providing advice and when she may just be providing investment education that does not require the adoption of fiduciary status.

D. The Department should expand the "seller's carve-out" to include sophisticated IRA and 401(k) plan investors.

The rationale for providing a seller's carve out for large plans in the Proposed Conflict of Interest Rule should be extended to sophisticated plan participants and IRA owners. A participant or IRA owner with a large balance, or with substantial assets or income, should be able to understand after basic disclosure that a broker or other sales representative is selling a product, and that there is no reasonable expectation of a fiduciary relationship. At some level of account balance or other measure of sophistication, a plan participant or IRA owner should – subject to similar disclosure obligations – be treated the same as a large plan for purposes of a carve-out from the Conflict of Interest Rule.

XI. Conclusion

Public Products meet the Department's apparent requirement of commonality with respect to retail investors and also contribute to the overall U.S. economy. As we've explained above, the controls and requirements imposed upon those who distribute the Public Products and on the products themselves (e.g., FINRA rules and NASAA Guideline requirements as to the suitability, expense limitations, related party transactions, disclosure, investor qualifications and suitability, maximum investment amounts, and merit state reviews) provide even higher standards than the regulatory standards placed on most of the investment products currently defined as "Assets" under the Proposed BIC Exemption. The suitability and maximum dollar investment thresholds imposed have the impact of lessening the possibility that unqualified investors will invest or that qualified investors will invest more than they should.

The Public Products generally perform well, enhance diversification, and improve the risk-adjusted return potential of an investment portfolio by adding a product in an asset class that does not correlate with the traded stock market. Public Products are also less volatile than many products that are currently defined as "Assets". They are highly transparent, provide per share valuations determined in accordance with regulatory requirements and industry standards of independence and methodology designed to result in the disclosure of reliable values, and the limited liquidity offered by Public Products is not inappropriate for a retirement account where the goal, unlike perhaps for a standard brokerage account, is to buy and hold for a long period of time.

For all the reasons set forth above, the IPA urges the Department to revise the Proposed BIC Exemption in order to include Public Products within the scope of the Proposed BIC Exemption either by doing away with a legal list of Assets or by adding the Public Products, as defined above, to that list. We appreciate your time and attention in ensuring that retirement investors are provided with the broadest array of investment options, while taking all reasonable measures to avoid conflicted advice.

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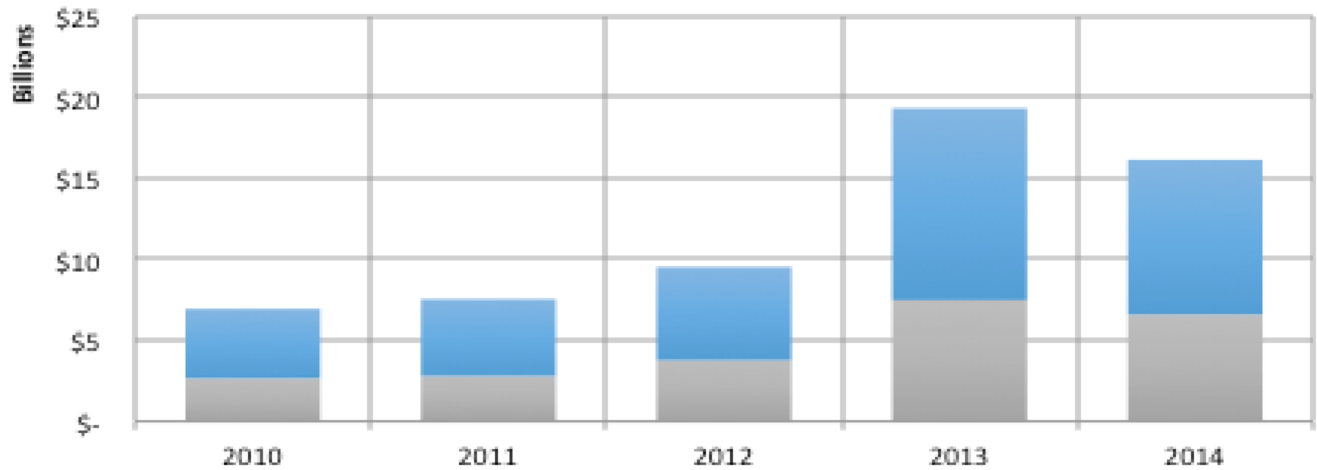
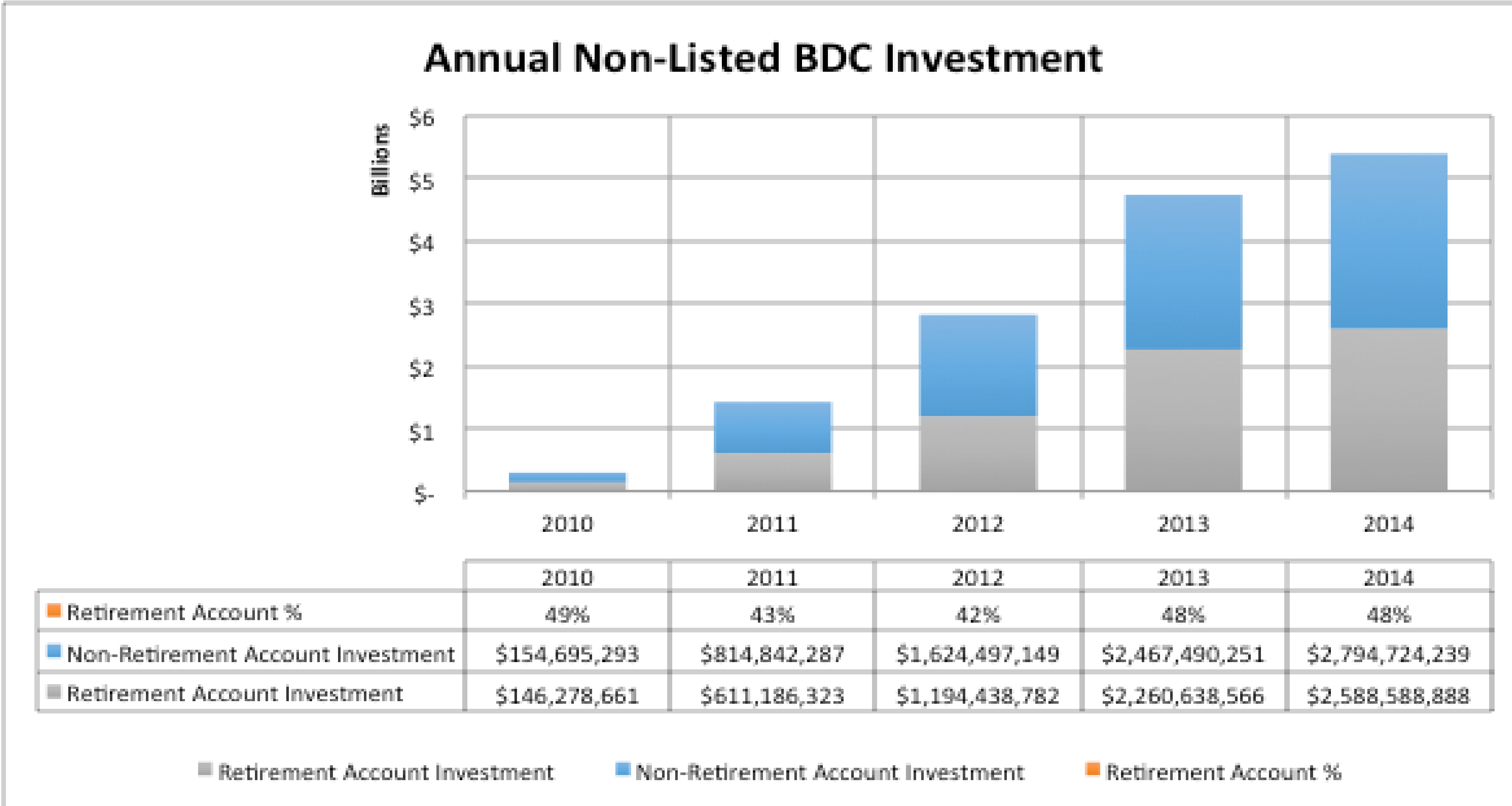
THE NON-LISTED REIT AND BDC MARKET

Annual Non-Listed REIT Investment



	2010	2011	2012	2013	2014
Retirement Account %	38%	37%	40%	39%	41%
Non-Retirement Account Investment	$4,283,225,933	$4,746,520,682	$5,749,767,825	$11,829,677,028	$9,534,552,240
Retirement Account Investment	$2,647,720,555	$2,793,223,924	$3,756,657,555	$7,462,934,933	$6,590,468,435

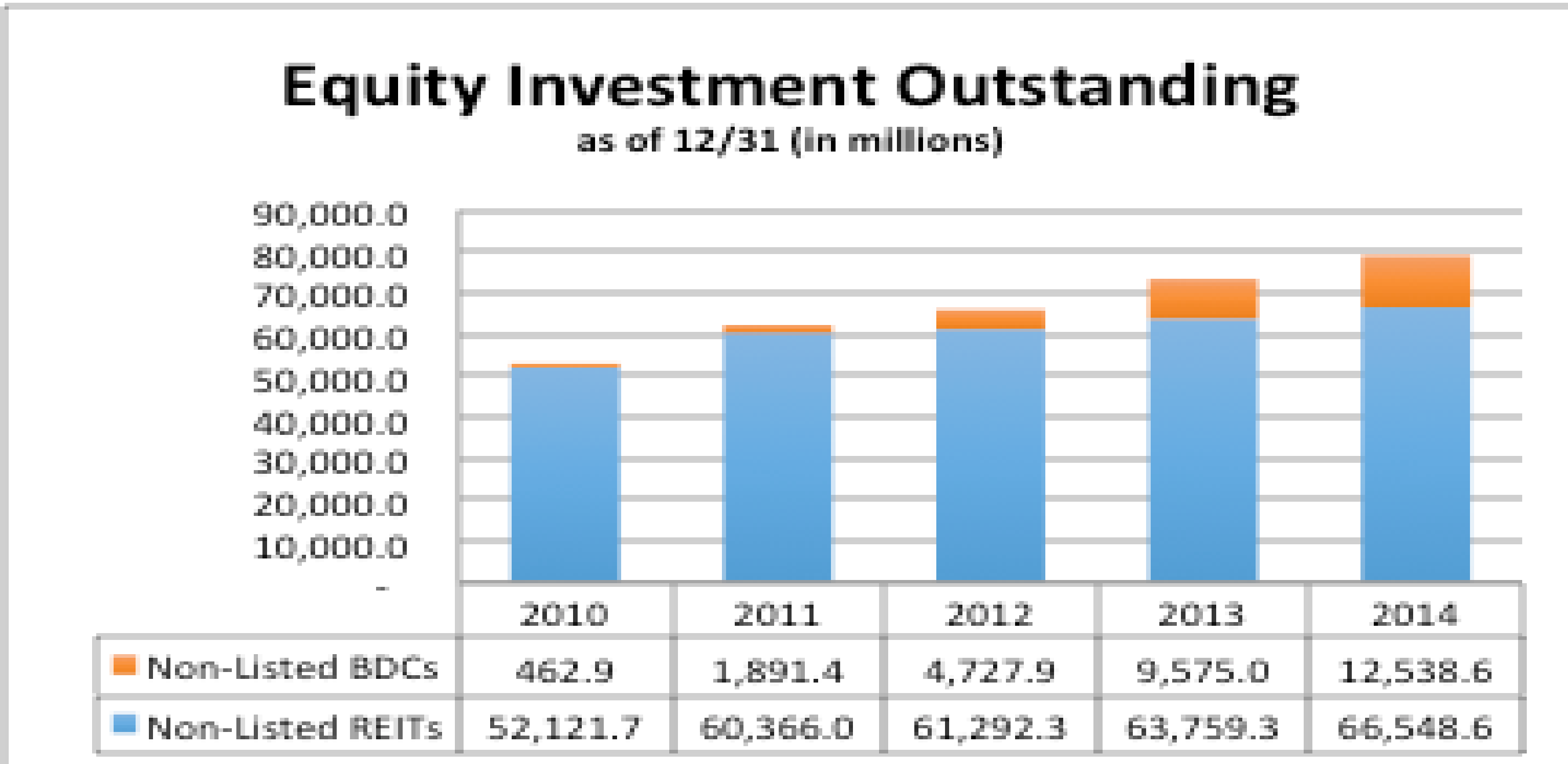
Retirement Account Investment   Non-Retirement Account Investment   Retirement Account %



	2010	2011	2012	2013	2014
Retirement Account %	49%	43%	42%	48%	48%
Non-Retirement Account Investment	$154,695,293	$814,842,287	$1,624,497,149	$2,467,490,251	$2,794,724,239
Retirement Account Investment	$146,278,661	$611,186,323	$1,194,438,782	$2,260,638,566	$2,588,588,888

Source: DST Systems, US Investment Record Keeping Solutions[1]

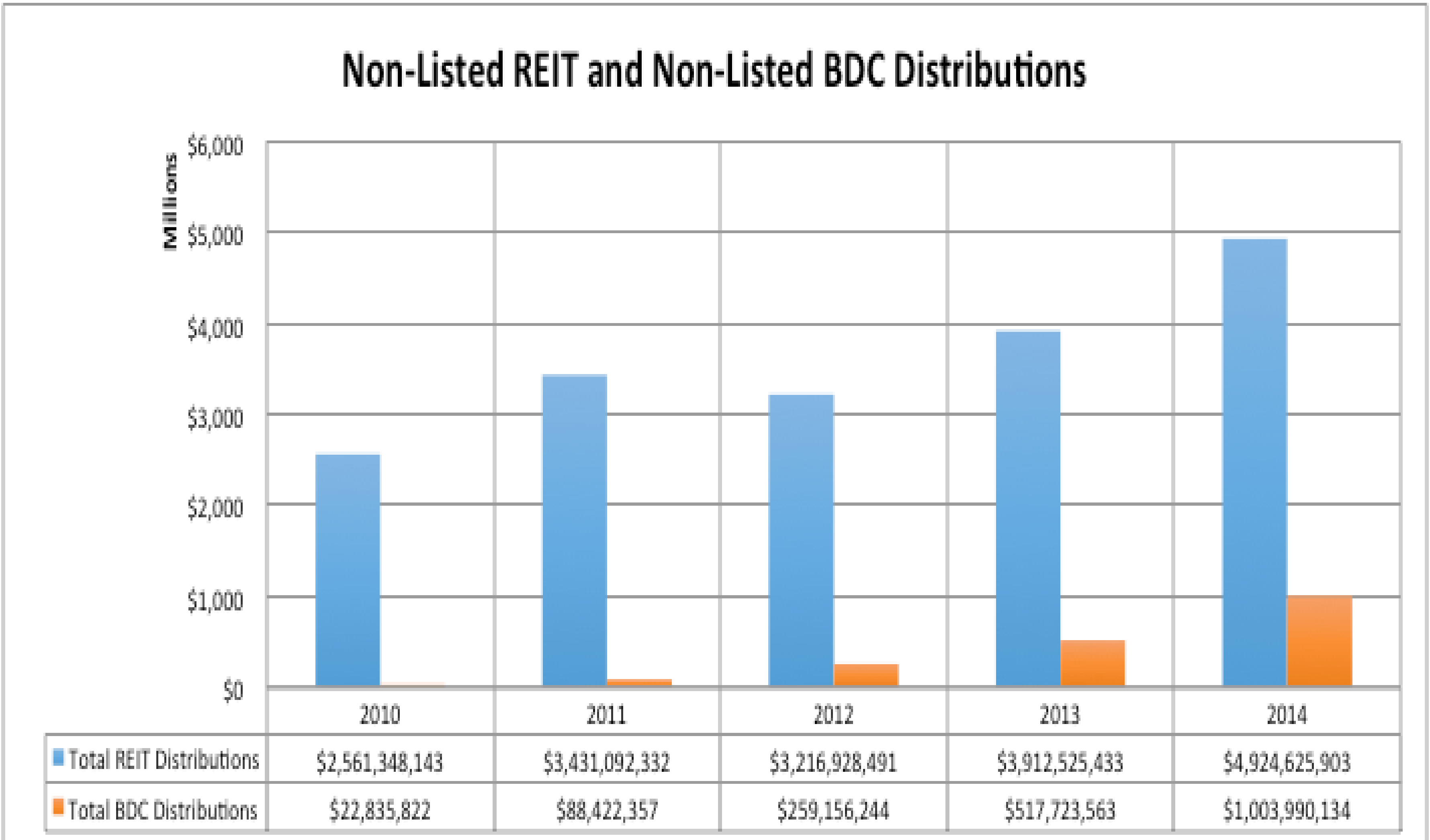
In 2014, individual investors invested a total of $21.7 billion in non-listed REITs and non-listed BDCs. Qualified percentage represents the dollar amount held in retirement accounts.



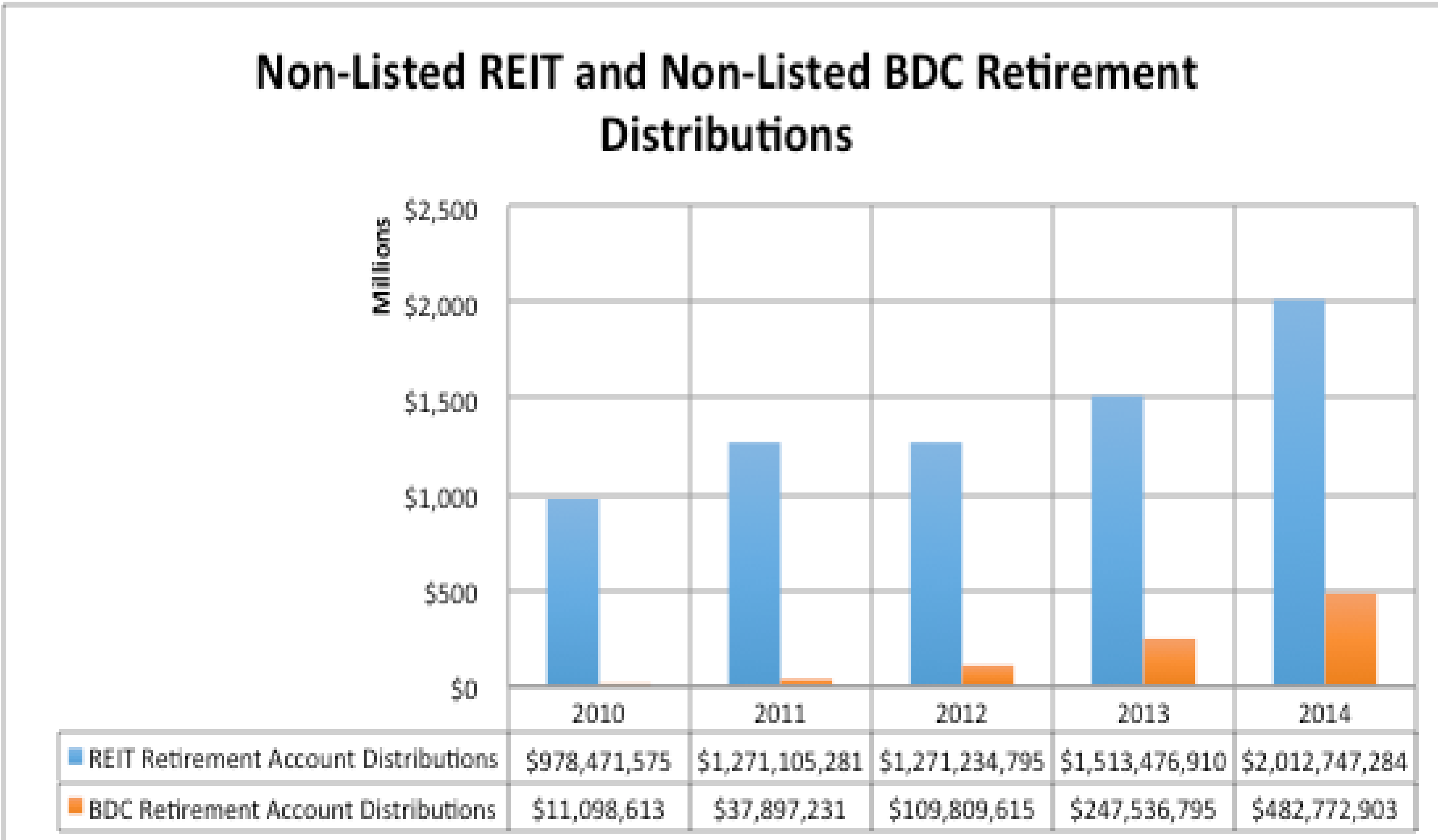
	2010	2011	2012	2013	2014
Non-Listed BDCs	462.9	1,891.4	4,727.9	9,575.0	12,538.6
Non-Listed REITs	52,121.7	60,366.0	61,292.3	63,759.3	66,548.6

Source: DST Systems, US Investment Record Keeping Solutions[1]

Equity Investment Outstanding represents the cumulative investment in previous years less monetization events such as listings, mergers or acquisitions of the programs represented. It is a measurement very similar to assets under management or AUM.

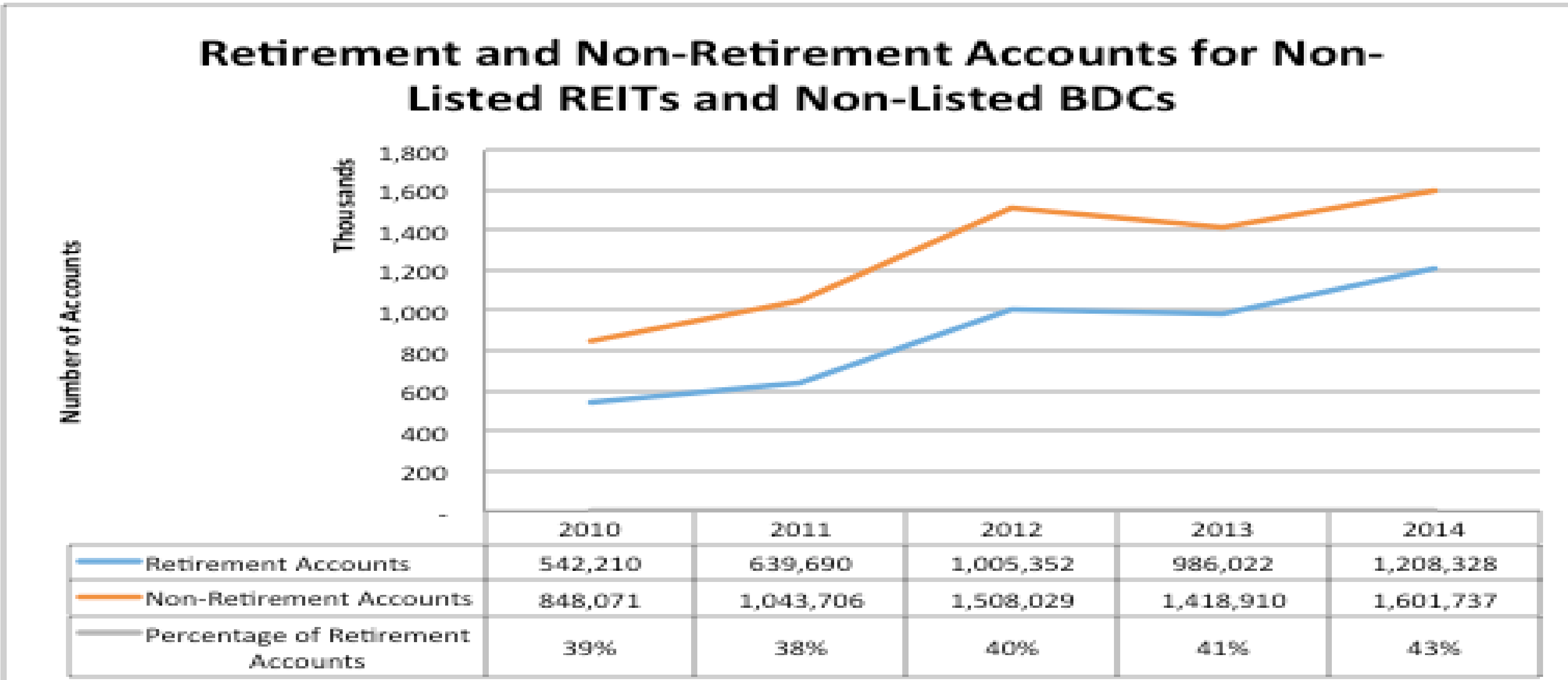


Investors received a total of $5.9 billion in distributions from non-listed REIT and BDC firms in 2014.



Source: DST Systems, US Investment Record Keeping Solutions[1]

Non-listed REIT and BDC firms distributed a total of $2,549,304,895 to retirement account holders in 2014.



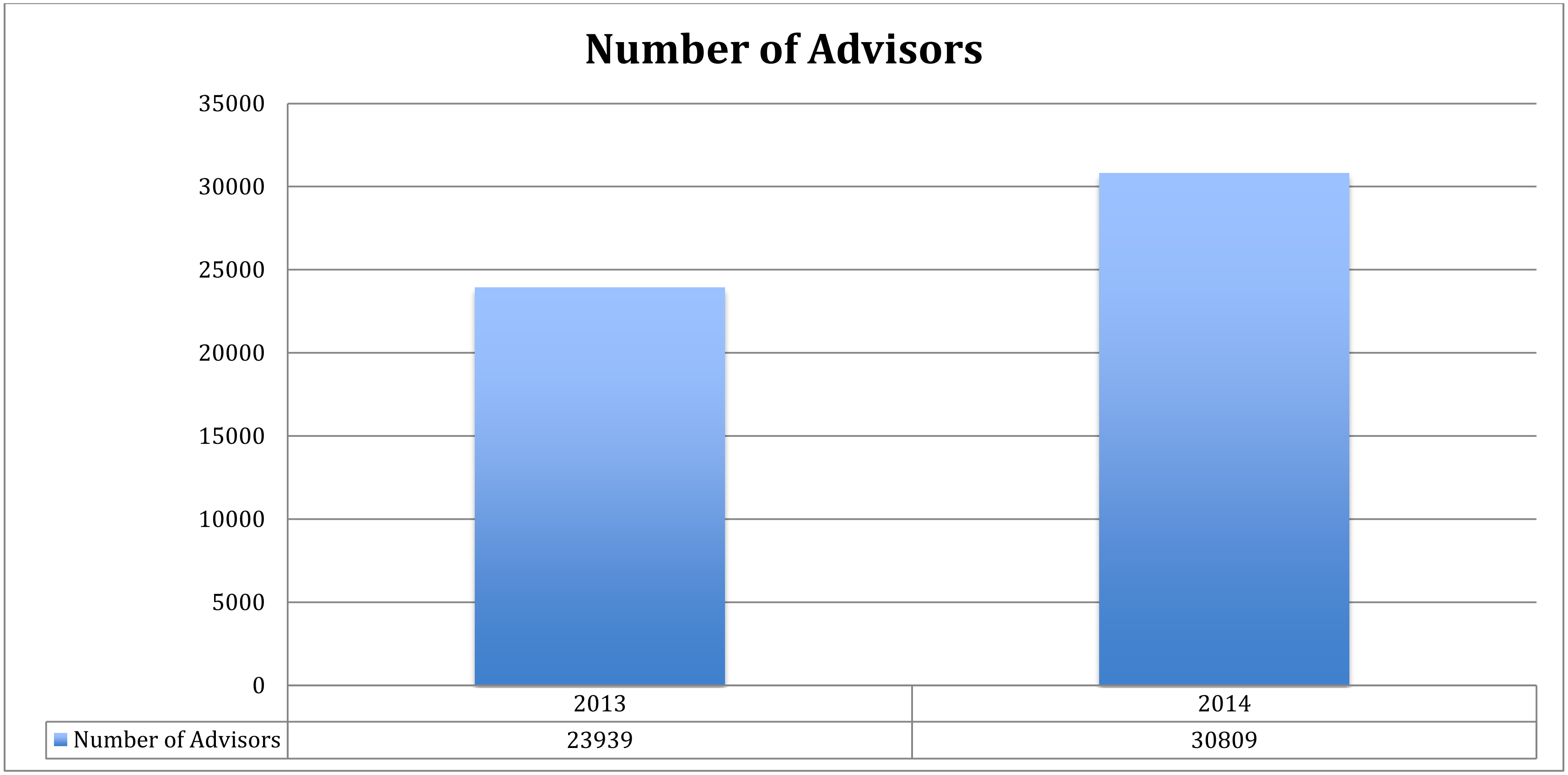
	2010	2011	2012	2013	2014
Retirement Accounts	542,210	639,690	1,005,352	986,022	1,208,328
Non-Retirement Accounts	848,071	1,043,706	1,508,029	1,418,910	1,601,737
Percentage of Retirement Accounts	39%	38%	40%	41%	43%

Source: DST Systems, US Investment Record Keeping Solutions[1]

Retirement and Non-Retirement Account Information

Of 2,810,065 open accounts as of December 31, 2014, 43% of those, or 1,208,328, were retirement accounts. The retirement accounts are predominantly IRAs. This percentage represents the number of accounts that are considered retirement accounts and differs from earlier percentages that reflected dollars invested. As an example in 2014 43% of all accounts were retirement accounts while 41% of dollars invested in non-listed REITs were in retirement accounts and 48% of dollars invested in BDCs were in retirement accounts. One measure is for accounts represented while the other represents dollar investment. Because they represent different metrics, they will not be equal.

The chart above demonstrates the number of accounts that were open across both non-listed REITs and BDCs for each year. As each year represents the total number of open accounts, not simply accounts opened in that year, some accounts will be included in multiple years. When a non-listed REIT or BDC lists on an exchange or otherwise provides a shareholder with an exit event, those accounts are no longer included in the annual tally. Though annual account totals will provide context, 2014 totals will demonstrate the most accurate view of current client usage of non-listed REITs and BDCs.



Source: DST Systems, US Investment Record Keeping Solutions[1]

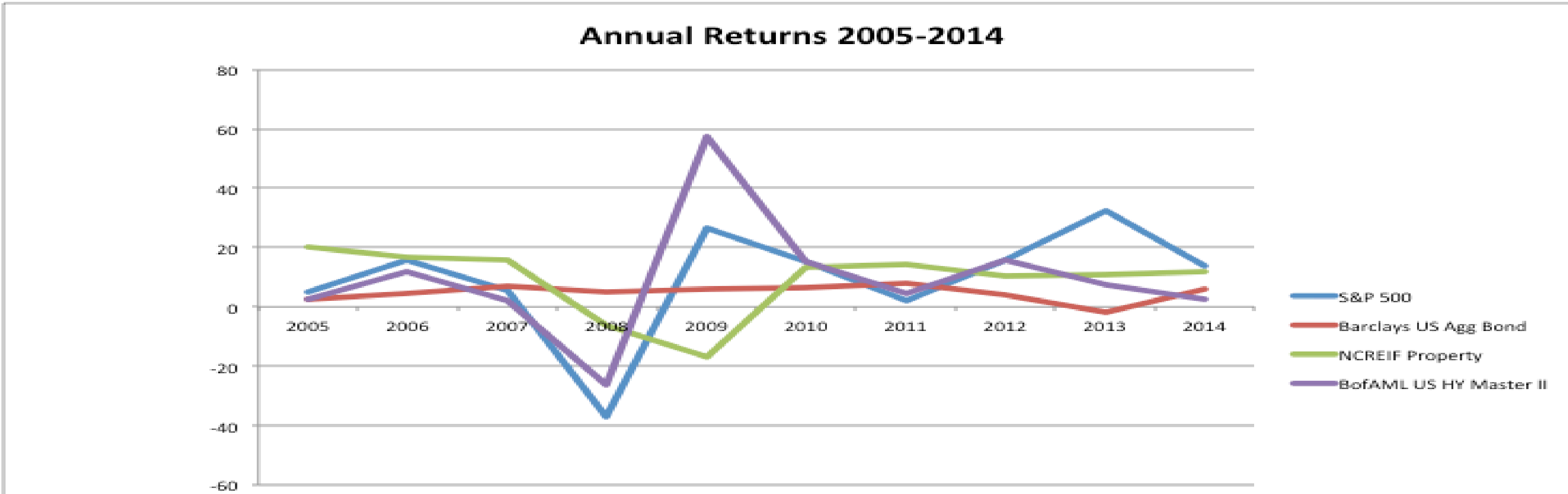
The above chart shows the number of advisors with at least one client account invested in either non-listed REITs or BDCs under supervision in each year. These may include both retirement and non-retirement accounts.

<u>PORTFOLIO CONSTRUCTION USING NON-LISTED REITS AND BDCS</u>

Index Returns and Standard Deviation (Quantifiable Risk)

Asset Class	Index	Morningstar Title	Avg. Annual Return*	Risk (Standard Deviation)
Stock Proxy	S&P 500	S&P 500 TR USD	9.5%	18.8%
Bond Proxy	BarCap Aggregate Bond Index	Barclays US Agg Bond TR USD	4.7%	2.8%
Commercial Real Estate (Non-Listed REIT Proxy)	NCREIF	NCREIF Property	9.0%	11.5%
Small Company Debt (Non-Listed BDC Proxy)	BofA Merrill Lynch High Yield Master II	BofAML US HY Master II TR USD	9.3%	20.7%

*Arithmetic mean
For 10 year period January 1, 2005 through December 31, 2014



	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
S&P 500	4.91	15.79	5.49	-37	26.46	15.06	2.11	16	32.39	13.69
Barclays US Agg Bond	2.43	4.33	6.97	5.24	5.93	6.54	7.84	4.21	-2.02	5.97
NCREIF Property	20.06	16.59	15.84	-6.46	-16.86	13.11	14.26	10.54	10.99	11.81
BofAML US HY Master II	2.74	11.72	2.24	-26.39	57.51	15.19	4.38	15.59	7.42	2.5

Source: Morningstar EnCorr[2]

The indices above represent the 4 primary asset classes that we will use for portfolio analysis. The S&P 500 is a common representative of domestic equities and the BarCap Aggregate Bond Index does the same for domestic debt in the form of bonds. The National Council of Real Estate Investment Fiduciaries (NCREIF) Property index is an index of commercial real estate and the BofA Merrill Lynch High Yield Master II Index does the same for small company US debt, the primary investment for non-listed BDCs.

The NCREIF Index provides the closest measure of the commercial real estate performance that occurs inside a non-listed REIT. In addition, it is the preferred index for FINRA reviewed client materials demonstrating REIT performance. NAREIT is used in the public space for portfolio analysis but because the market determines the REIT net asset value while non-listed REITs primarily use professional real estate appraisals to derive NAV, NAREIT is not an appropriate benchmark. Additional information about NCREIF can be found in the source notes following the full analysis.

Similarly, the BofA Merrill Lynch High Yield Master II Index is a common benchmark for BDCs that concentrate holdings on debt investments. While BDCs do have the flexibility to invest in equity, non-listed BDCs are focused on debt and the use of this index is an appropriate measure of performance.

Average annual return is the average of each individual year from 2005 through 2014 using arithmetic mean. Standard deviation is used to quantify risk. Standard deviation represents the amount that an asset class has fluctuated around the mean in the time period measured. Using standard normalized statistical distribution, that would mean that 68% of occurrences are within one standard deviation and 95% of occurrences are within 2 standard deviations. Therefore a higher standard deviation represents higher volatility resulting in higher overall risk.

Income Needs

Investment Vehicle	Yield
10 Year US Treasury	2.26%
US Aggregate Bond Index	2.34%
S&P 500 Dividend Yield	1.93%
Traded REITs Dividend Yield	3.72%
Non-Listed REITs Average	6.39%
Non-Listed BDCs Average	7.33%

Yields are as of market close on June 19, 2015 and net of fees. Sources: Various

Asset Class Correlation Matrix

Asset Class	Index	Stocks	Bonds	Non-Listed REITs	Non-Listed BDCs
Stock Proxy	S&P 500 TR USD	-	-	-	-
Bond Proxy	Barclays US Agg Bond TR USD	(0.35)	-	-	-
Commercial Real Estate	NCREIF Property	0.15	(0.13)	-	-
Small Company Debt	BofAML US HY Master II TR USD	0.74	0.07	(0.38)	-

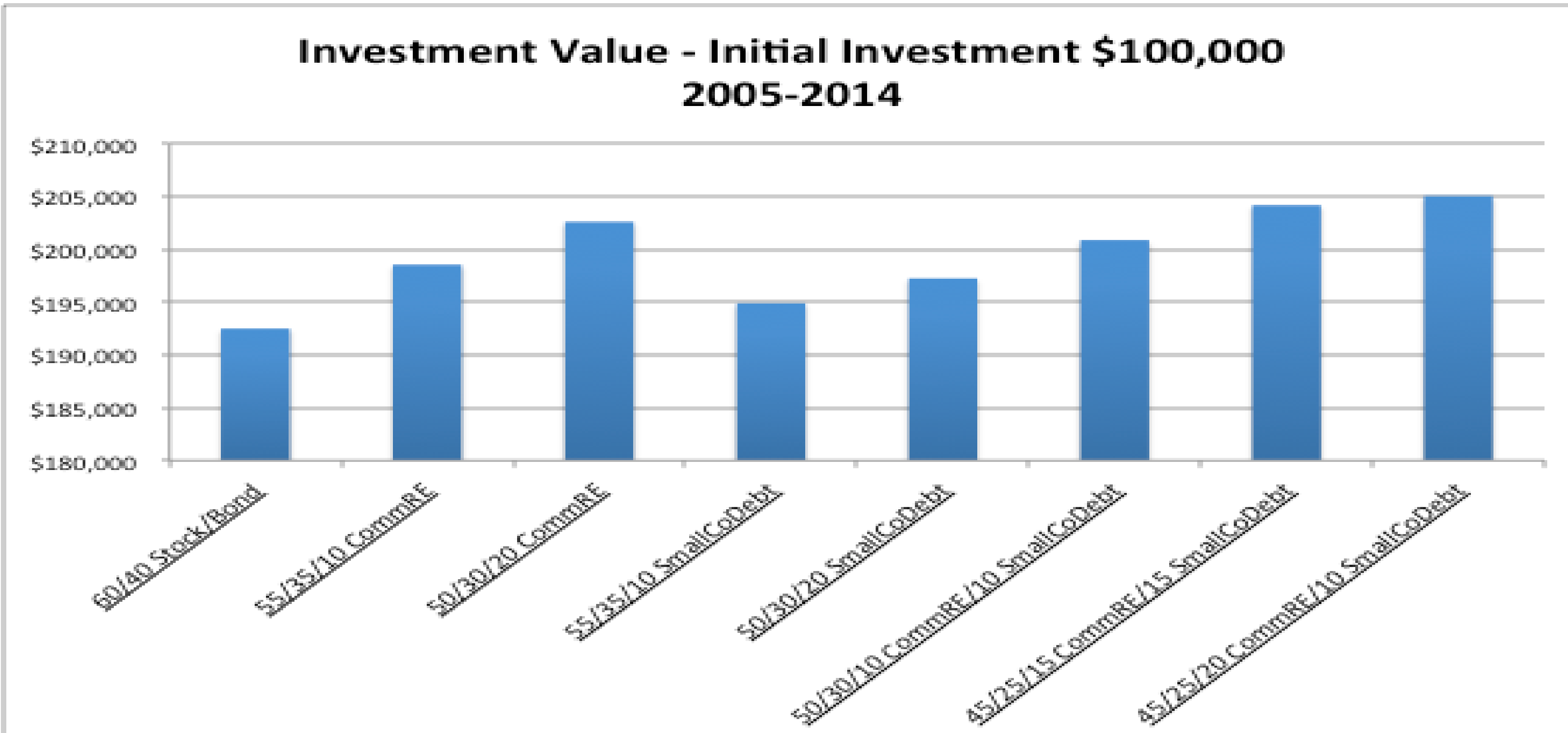
For 10 year period January 1, 2005 through December 31, 2014

Because standard deviation calculates the expected movement, or volatility, of an asset class, it is often used to quantify risk. As we know from Dr. Harry Markowitz's Modern Portfolio Theory, the addition of a risky asset class can have the effect of paradoxically reducing risk of the entire portfolio. So while standard deviation is useful, we must also know how the asset classes move relative to each other to maximize the benefit of real estate (non-listed REITs) and small company debt (non-listed BDCs) in a portfolio.

Correlation is helpful in portfolio analysis so that we can more fully understand how different asset classes move in relation to each other. A correlation of '1' means that the asset types move in tandem while a correlation of '-1' would mean that they move exactly inversely to each other. In other words, a 10% drop in one asset class is offset by a 10% gain in the perfectly negatively correlated asset class. A correlation of '0' means that no correlative effect can be derived and that the asset types do not move relative to each other in any way.

Correlation quantifies the most impactful diversifiers for a portfolio. In the chart above for instance, small company debt is correlated closely to stocks (.74) but has almost no correlation (.07) to bonds. That would suggest that adding debt focused non-listed BDCs to a portfolio of bonds will diversify the risk in the portfolio. This is because the small company debt index will not move the same way that bonds do because they have almost no correlation (.07) to each other. However, the closely mirrored movement to stocks means that the addition of debt focused non-listed BDCs to a stock portfolio, while still beneficial, will not have the proportionate diversifying effect since they move very similarly as indicated by a correlation of .74. Commercial real estate has a very low correlation to all other asset classes. It is for this reason that commercial real estate remains a powerful diversifier in portfolio construction. The chart above illustrates similar conclusions about any pairing of the 4 asset classes we are examining. Each of the correlations is sufficiently large to signify that when compared to stocks, both small company debt and commercial real estate add a diversifying component to a portfolio.

Portfolio Models with Varying Commercial Real Estate and Small Company Debt Allocations



For 10 year period January 1, 2005 through December 31, 2014

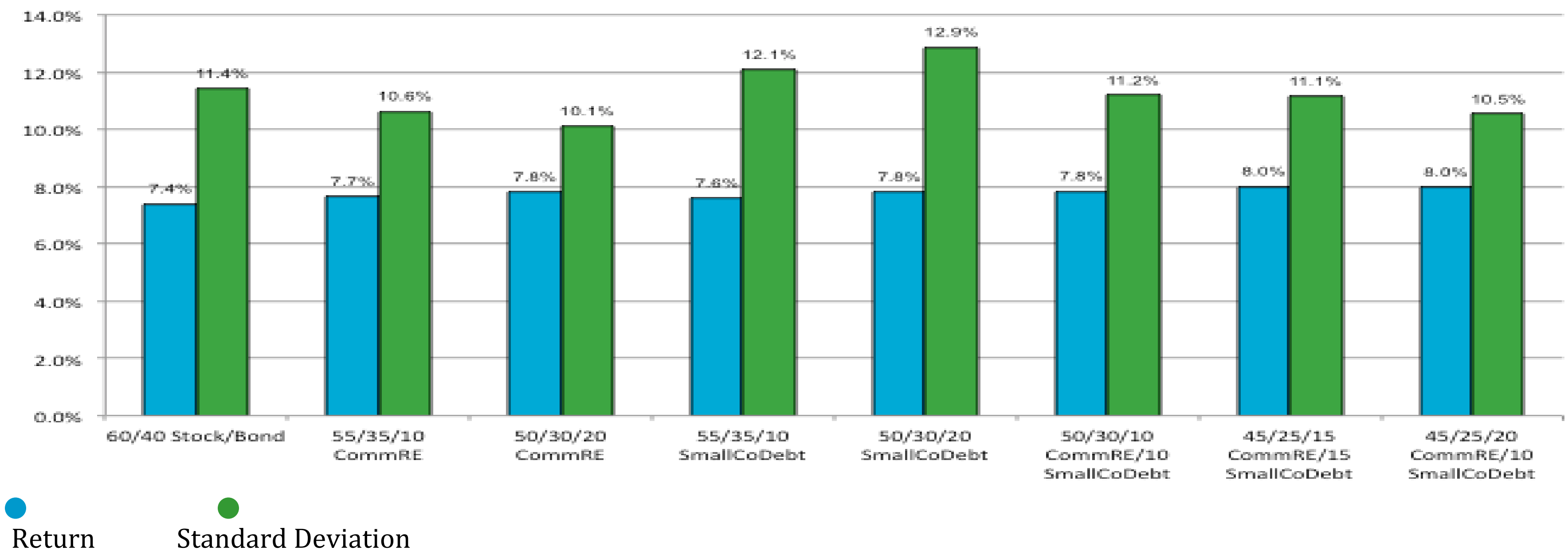
This chart is a comparison of 8 different portfolios and how a $100,000 investment would fare over the 10 year time period covering 2005 – 2014.

The returns above represent the 4 primary asset classes that we are using for portfolio analysis. The S&P 500 is a common representative of domestic equities and the BarCap Aggregate Bond Index does the same for domestic debt in the form of bonds. The NCREIF Property index is an index of commercial real estate and the BofA Merrill Lynch High Yield Master II Index does the same for small company US debt, the primary investment for non-listed BDCs.

In each portfolio the largest percentage is represented by the S&P 500 as a domestic equity investment and the second largest percentage is a bond investment represented by the BarCap Aggregate Bond Index. We have then used varying, small allocations to commercial real estate and small company debt as represented by the NCREIF Property index and the BofA Merrill Lynch High Yield Master II Index. These allocations highlight the effect of commercial real estate and small company debt in a conventional stock/bond portfolio.

None of the indices being used are available for direct purchase. Even purchases of an S&P 500 index security are mutual funds or ETFs that mirror but, due to fees, cannot replicate the index. However, each of these indices is the most common benchmark for asset managers investing in the respective asset class. In 2014, only 13.56% of large cap mutual fund managers beat the benchmark S&P 500 index (Source: S&P Dow Jones Indices LLC, CRSP) and over the 10 year period ending December 31, 2014 only 17.93% beat the index. However, 31% of non-listed REIT managers outperformed the NCREIF index after fees as reported by Dr. Jay Hartzell and Dr. Jung-Eun Kim in the 2014 Full Cycle Performance Study published by Blue Vault and the University of Texas. Roughly twice as many non-listed REIT managers outperformed their index in comparison to large cap equity managers.

Portfolio Returns and Standard Deviation (Quantifiable Risk)



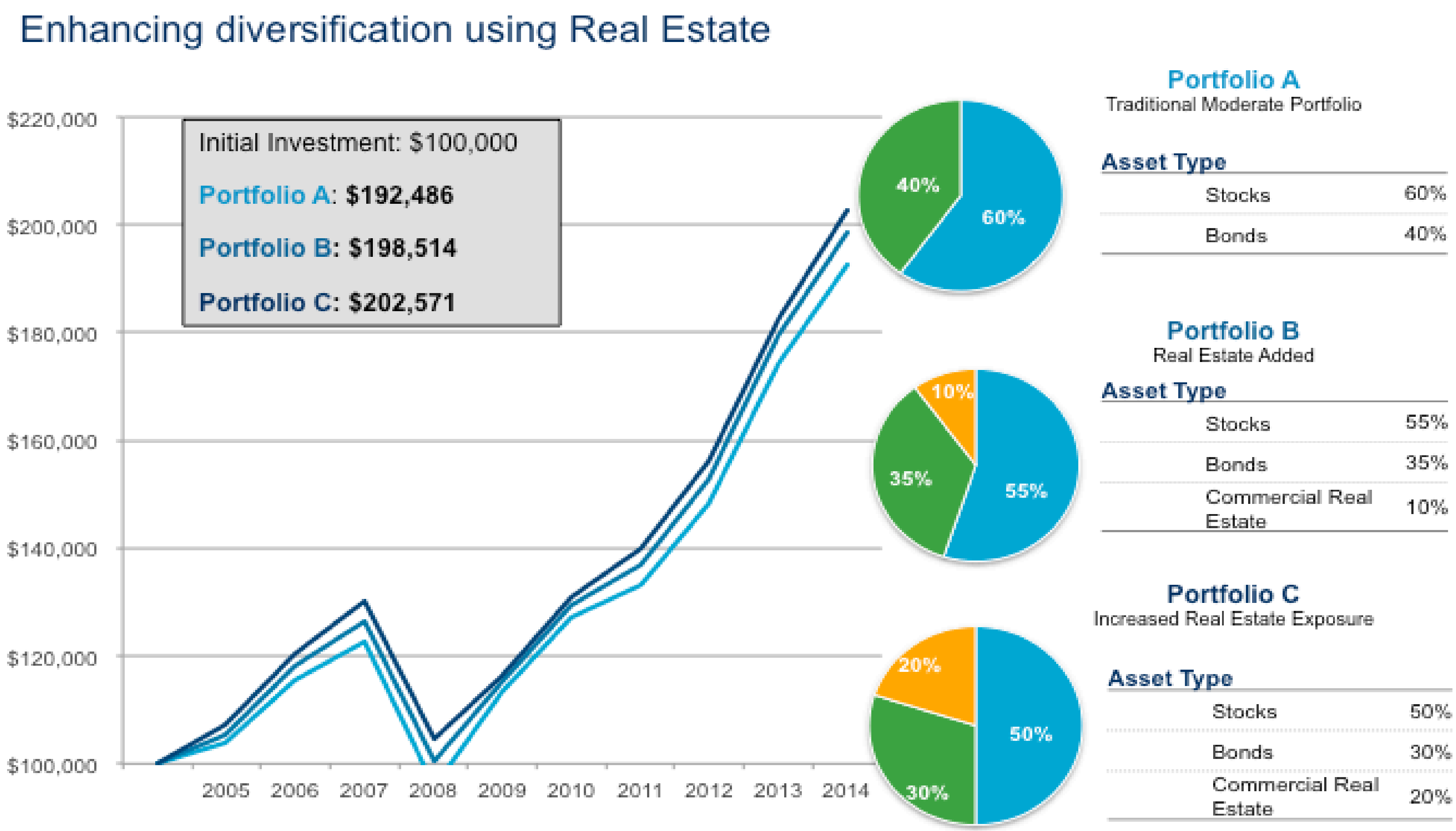
For 10 year period January 1, 2005 through December 31, 2014

This chart is a comparison of 8 different portfolios and the average annual return with standard deviation over the 10 year time period covering 2005 – 2014. The portfolios mirror the previous chart demonstrating a $100,000 investment.

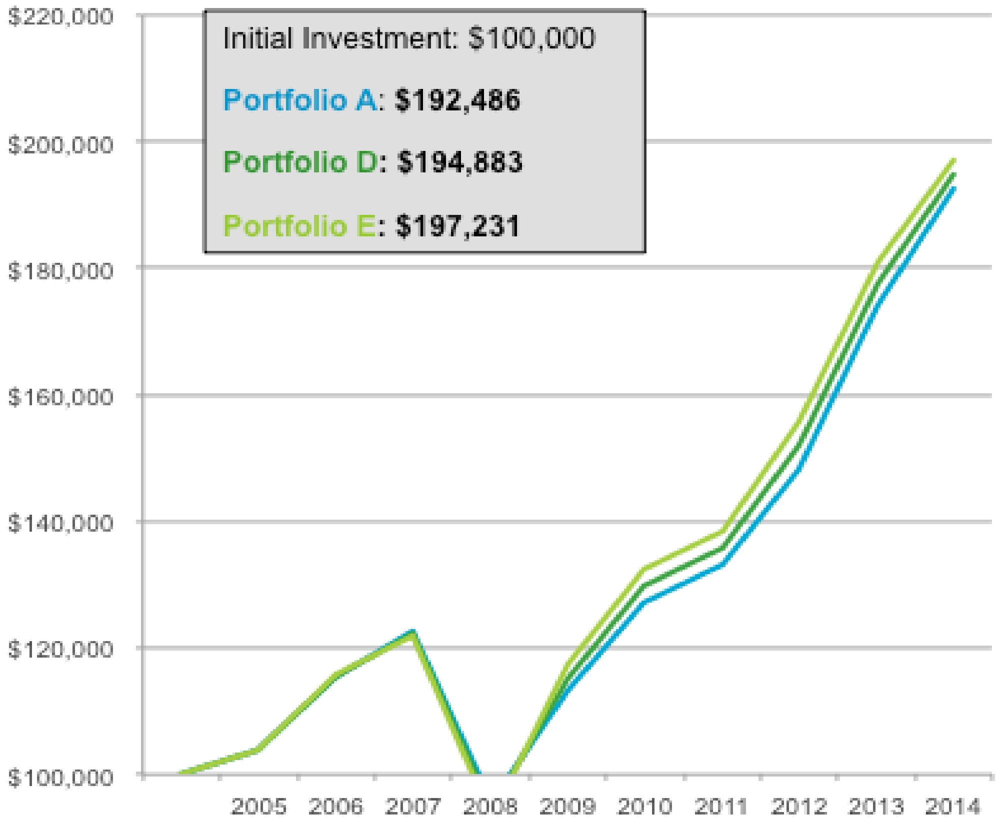
The indices above represent the 4 primary asset classes that we are using for portfolio analysis. The S&P 500 is a common representative of domestic equities and the BarCap Aggregate Bond Index does the same for domestic debt in the form of bonds. The NCREIF Property index is an index of commercial real estate and the BofA Merrill Lynch High Yield Master II Index does the same for small company US debt, the primary investment for non-listed BDCs.

The NCREIF Index provides the closest measure of the commercial real estate performance that occurs inside a non-listed REIT. In addition, it is the preferred index for FINRA reviewed client materials demonstrating REIT performance. NAREIT is used in the public space for portfolio analysis but because the market determines the REIT net asset value while non-listed REITs primarily use professional real estate appraisals to derive NAV, NAREIT is not an appropriate benchmark. Additional information about NCREIF can be found in the source notes following the full analysis.

Model Portfolio Detail

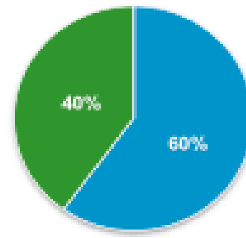


Enhancing diversification using Small Company Debt



Portfolio A

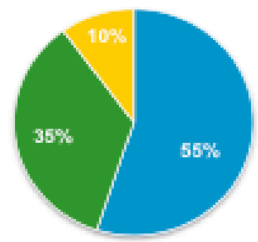
Traditional Moderate Portfolio



Asset Type	
Stocks	60%
Bonds	40%

Portfolio D

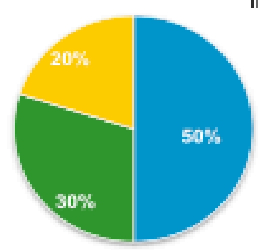
BDCs Added



Asset Type	
Stocks	55%
Bonds	35%
Small Company Debt	10%

Portfolio E

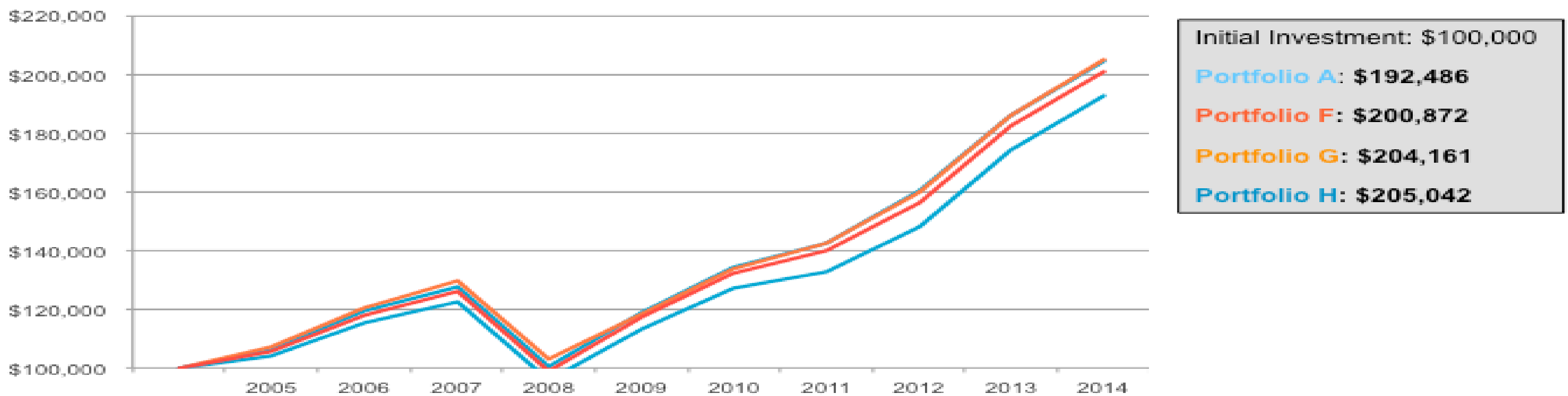
Increased BDC Exposure



Asset Type	
Stocks	50%
Bonds	30%
Small Company Debt	20%

Model Portfolio Detail, continued

Diversified Portfolios



Asset Type	Portfolio A	Portfolio F	Portfolio G	Portfolio H
Stocks	60%	50%	45%	45%
Bonds	40%	30%	25%	25%
Commercial Real Estate	0%	10%	15%	20%
Small Company Debt	0%	10%	15%	10%

Source Notes and Explanations

Investor Information

[1]Source: DST Systems, US Investment Record Keeping Solutions. DST is the primary recordkeeper for non-listed alternative investments. This information represents the activity of 55 programs out of 62 total programs open to new investors during 2014. While not a complete representation of the entirety of REITs and BDCs it represents 88.7% of total programs that raised capital in 2014 and 97.0% of capital raised. Data is available through the following DST services rendered to the REIT and BDC industry: Fund Accounting, Fund Administration, Shareholder Servicing, Compliance, Legal, Medallion Distribution, Series Trust Solution, Tax Administration, Customer Communication, Tender Offer Services. DST's primary responsibility is to report on financial transactions to individual customers. Because DST generates client reports for statements and distribution of dividends they serve as a conduit for recordkeeping between the non-listed REITs and BDCs and the investor. By aggregating this data we are able to view the entirety of financial transactions including raising capital, paying distributions, number of total accounts and the delineations between retirement and non-retirement investments or distributions.

Explanation of Indices

[2]Source: Institutions worldwide use Morningstar® EnCorr® to research, create, analyze, and implement optimal asset allocation strategies within a single software. This advanced analytical software unites proven finan- cial models, sophisticated Ibbotson methodologies, and comprehensive Morningstar investment data.
An innovative solution for conducting advanced statistical and graphical analyses, Morningstar EnCorr helps build portfolios designed to generate robust returns at varying risk levels. The software provides invaluable support to institutional investment professionals conducting in-depth portfolio research, including analysts, investment consultants, Registered Investment Advisors, and portfolio managers.

Stocks are represented by the Standard & Poor's 500®; Bonds by the BarCap Aggregate Bond Index; REITs by the NCREIF Property Index; BDCs by the BofA ML High Yield Master II. All portfolio allocations are rebalanced on a monthly frequency.

S&P Dow Jones U.S. indices are designed to reflect the U.S. equity markets and, through the markets, the U.S. economy. The S&P 500 focuses on the large-cap sector of the market; however, since it includes a significant portion of the total value of the market, it also represents the market. Companies in the S&P 500 are considered leading companies in leading industries. The S&P 500 is a member of the S&P Global 1200 family of indices. Source: S&P Dow Jones Indices: Index Methodology, March, 2015

The Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency). Provided the necessary inclusion rules are met, US Aggregate- eligible securities also contribute to the multi-currency Global Aggregate Index and the US Universal Index, which includes high yield and emerging markets debt. The US Aggregate Index was created in 1986 with history backfilled to January 1, 1976. Source: Barclays Index, Portfolio & Risk Solutions Benchmark Indices, May, 2014

The flagship index of NCREIF is the NPI, which is a quarterly index tracking the performance of core institutional property markets in the U.S.

The NCREIF Property Index is a quarterly time series composite total rate of return measure of investment performance of a very large pool of individual commercial real estate properties acquired in the private market for investment purposes only.

The objective of the NPI is to provide a historical measurement of property-level returns to increase the understanding of, and lend credibility to, real estate as an institutional investment asset class.

Comprised exclusively of operating properties acquired, at least in part, on behalf of tax- exempt institutions and held in a fiduciary environment.

Start date is the 4th Quarter of 1977; as of 2nd Quarter 2013 consisted of 7,099 properties with a gross fair market value of over $336 billion. Each property's return is weighted by its market value.

Includes properties with leverage, but all returns are reported on an unleveraged basis.

Includes Apartment, Hotel, Industrial, Office and Retail properties, and sub- types within each type.

A "composite" index defined by the membership of NCREIF analogous to the NYSE Composite Index based on the stocks listed on that exchange.

Source: NCREIF DATA, INDEX AND PRODUCTS GUIDE 2015 National Council of Real Estate Investment Fiduciaries

Bank of America Merrill Lynch High Yield Master II Index consists of below investment grade U.S. dollar denominated corporate bonds that are publicly issued in the US domestic and yankee bonds. Issues included in the index have maturities of one year or more and have a credit rating lower than BBB-/Baa3, but are not in default. The index includes domestic high-yield bonds, including deferred interest bonds and payment-in-kind securities. Source: Credit Suisse AG Glossary of Indices

Yield Sources

[3]10 year Treasury is the current yield on the United States Treasury 10 year Note and is a common benchmark for a US dollar denominated government-backed income source.
US Aggregate Bond Index is The Barclays US Aggregate Bond Index, a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market.

S&P 500 Dividend Yield as reported by Standard & Poor's by aggregating paid dividends of the 500 stocks represented in the S&P 500.

Traded REITs Dividend Yield is the yield of the the FTSE NAREIT US Real Estate Index Series and is calculated by FTSE International Limited.

Non-listed REITs and Non-listed BDCs are not represented directly by an index and, therefore, do not have a published yield like the other asset types reported in the table. Therefore, the yield has been calculated using the declared cash distributions of all programs that raised investment capital in 2014 as reported in the 10K filed with the SEC for the calendar year ending 12/31/2014. Stock distributions are not counted toward the yield, only cash distributions. In addition, the yield is reported on a weighted average basis based using the amount of investment for 2014 against the total investment for that asset type.

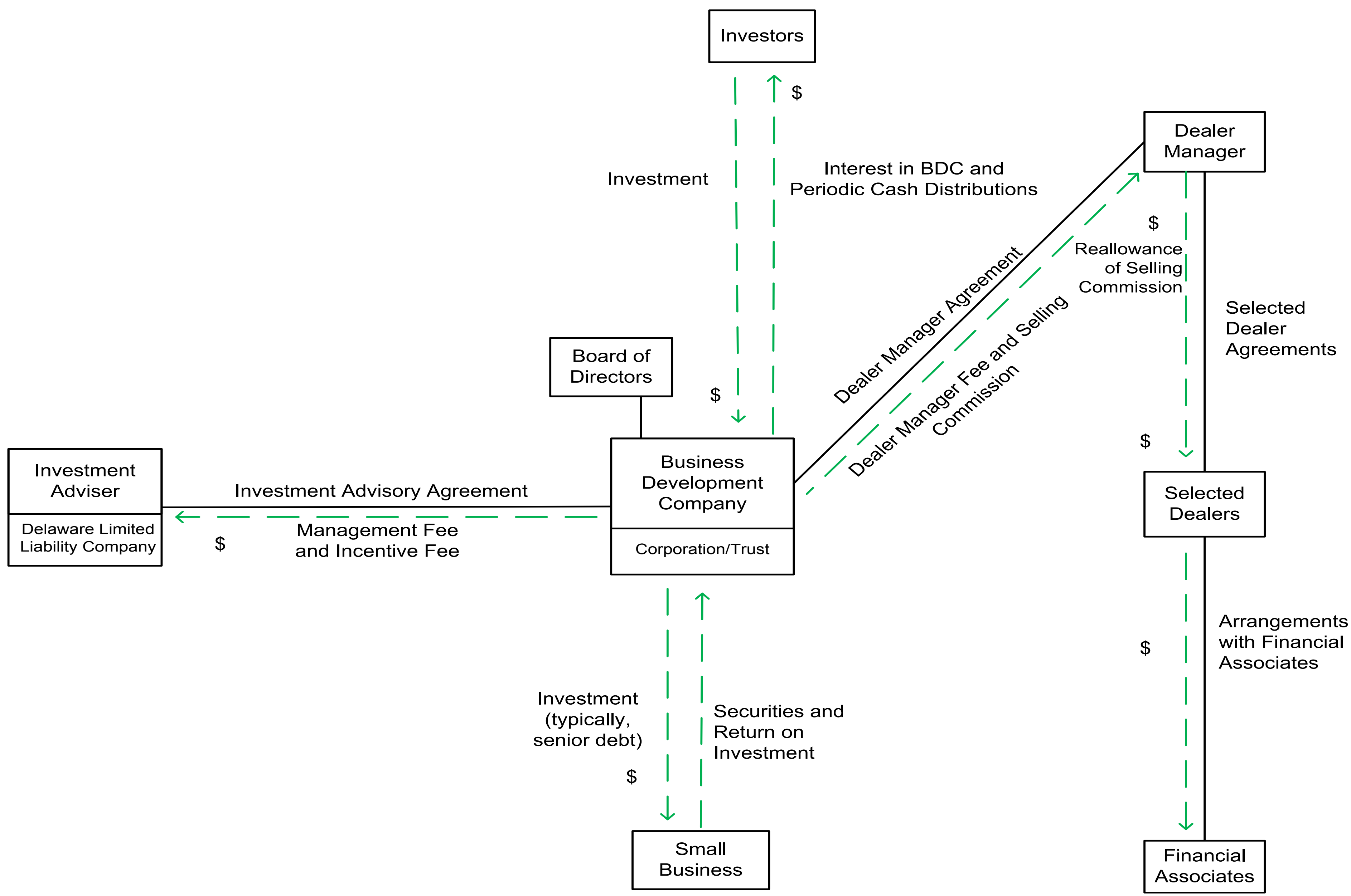
Attachment B to
the Comment Letter of the
Investment Program Association

NL BDCs and NL REITs:

Structures and Fees of Related Service Providers*

* The descriptions of the types of financial products included in this Attachment B are not drawn from a broad market survey. Some forms of the types of financial products depicted in this Attachment B may vary from the examples described herein with respect to structure, compensation arrangements and regulatory framework depending upon factors such as the circumstances of the sponsor, distributor or potential investor groups and the product distribution methodology. This Attachment B does not include a complete recitation of fees. For more information, please see the comment letter to which this Attachment B is attached.

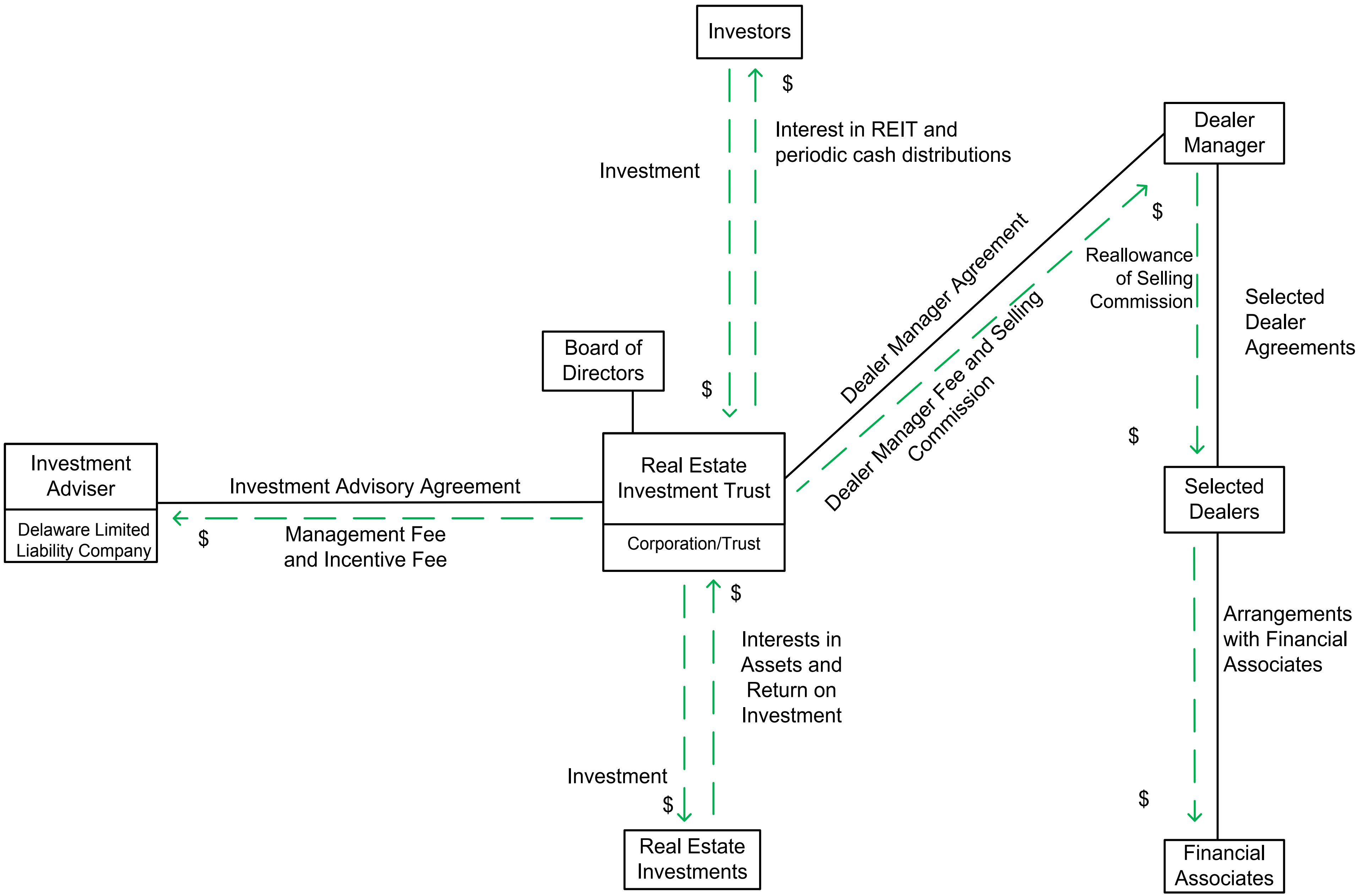
Public, Non-Listed Business Development Company ("NL BDC")



VISIO (revise Visio Chart NAI-1500381524v1)

NAI-1500446305v1

Public, Non-Listed Real Estate Investment Trust ("NL REIT")



VISIO (right click – Visio object/open)

NAI-1500446305v1

July 21, 2015

Submitted Electronically – e-ORI@dol.gov and e-OED@dol.gov

Office of Regulations and Interpretations
Office of Exemption Determinations
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Ave., NW
Washington, DC 20210

**Re: Definition of the Term "Fiduciary" (RIN 1210-AB32);
Best Interest Contract Exemption (ZRIN 1210-ZA25)**

Ladies and Gentlemen:

The Investment Program Association ("IPA") submits the following comments with respect to the rule proposed by the U.S. Department of Labor (the "Department") which would define who is a "fiduciary" by reason of providing investment advice for a fee or other compensation (the "Proposed Conflict of Interest Rule"[1]) and the related proposed Best Interest Contract Exemption (the "Proposed BIC Exemption"[2]). The IPA appreciates the opportunity to comment on this important regulatory action.

The IPA was formed in 1985 to provide effective national leadership for the direct investment industry. The IPA supports individual investor access to a variety of asset classes whose returns have low or negative correlations with the returns from exchange-traded securities and products which invest primarily in exchange-traded securities. Many of these investment opportunities have historically been available only to institutional investors (the "IPA Products").[3] Included among the IPA Products are privately offered real estate private equity funds. The IPA has submitted a comment

1 U.S. Department of Labor, Notice of Proposed Rulemaking, *Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice*, 80 Fed. Reg. 21928 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pt. 2509 and 2510), available at: http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28201.

2 U.S. Department of Labor, Notice of Proposed Class Exemption, *Proposed Best Interest Contract Exemption*, 80 Fed. Reg. 21960 (proposed Apr. 20, 2015) (to be codified at 29 C.F.R. pt. 2550), available at: http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28202.

3 Returns from asset classes that have low or negative correlations to exchange-traded securities and products generally do not move parallel with traded markets. This results in a type of diversification that assists in reducing risk resulting from market swings.

letter concerning certain publicly registered, non-listed investments included among IPA Products (the "Public Products Comment Letter"). This letter addresses a category of IPA Products which are privately offered – real estate private equity funds ("PE Funds"[4]). These PE Funds are more fully described below. For 30 years the IPA has successfully championed the growth and improvement of the IPA Products, which have increased in popularity with financial professionals and investors alike. Today, PE Funds function as a critical component of effectively diversified investment portfolios and serve an essential capital formation function for the U.S. economy.

The IPA serves the investment community through advocacy, collaboration, and education regarding these "direct investments," and by establishing and encouraging enhanced transparency, appropriate suitability screening and use of IPA Products, and best practices on the behalf of the investing public.[5]

EXECUTIVE SUMMARY

The IPA's primary concerns, in connection with the Proposed BIC Exemption, relate to two issues: (i) the Department's apparent substitution of a "legal list" of acceptable (and presumably "worthy") assets in place of its traditional principles-based approach; and (ii) the definition of "Assets." With respect to item (ii), the Department has requested comment on the proposed definition of "Assets" and has specifically asked that commenters who believe that additional investments should be included in the scope of the exemption provide the Department with full descriptions of those products, as well as information supporting the position that the products are a "common investment for retail investors."[6]

The IPA respectfully submits that the retreat from a principles-based approach to a "legal list" of "Assets" available to retirement investors for the purpose of the BIC Exemption will stifle product innovation and deny retirement investors the ability to access new investment categories, structures and products which may provide enhanced financial benefits and/or reduced risks. To avoid the negative consequences of this approach, the Department must have the ability and resources to regularly, continually, and timely consider and analyze new investment products for inclusion as an Asset, which may not be practicable. As a result, the Asset list process will create a category of

4 The IPA supports additional products, but PE Funds are the only products supported by the IPA that are discussed herein.

5 A more complete description of IPA activities can be found in the Public Products Comment Letter.

6 Proposed BIC Exemption, 80 Fed. Reg. 21967.

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investors who are not able to take advantage of market evolutions and improvements. The IPA, therefore, believes that the "Asset" list approach should be discarded in favor of a principles-based approach.

The IPA also respectfully submits that if the Department determines to proceed with an "Asset" list approach, then PE Funds, as defined and described herein, should be included in the "legal list" of "Assets." This position is supported by the following facts:

- PE Funds are compatible with the objectives of retirement investors in that they can provide superior reliable income, inflation protection, and capital growth to preserve the purchasing power of savings during retirement.

- PE Funds are commonly used securities in the portfolios of retired, accredited investors.

- PE Funds provide retirement investors with access to the same strategy, which is used by the nation's leading public and private pension and endowment plans in that they provide portfolio diversification into an asset class, real estate, which has historically had a low correlation with exchange-traded financial products, thereby reducing portfolio risk and increasing risk-adjusted returns.

- PE Funds provide retirement investors with the opportunity to benefit from professional management of direct investments in real properties by organizations which have significant experience and expertise in the asset class.

- PE Funds have compensation provisions which are driven by active and competitive private equity capital market forces.

- While they do not issue publicly registered securities, PE Funds are nevertheless subject to substantial regulation at the federal and state level, which provides significant investor protections. In addition, broker-dealers are subject to extensive requirements relating to due diligence reviews and determinations of the merits and suitability of PE Funds for individual investors.

- Under existing regulations, access to PE Funds is limited to investors who have the financial resources and knowledge and experience in financial and business matters to make fully informed decisions regarding the merits and risks of a PE Fund investment.

Despite these facts, PE Funds have not been included in the Department's proposed list of "Assets," making these privately offered and strategically useful investments unavailable to qualified IRA investors. The IPA believes that PE Funds[7] should be included as "Assets" within the Proposed BIC Exemption either by the removal by the Department of a "legal list" of "Assets" or by the inclusion of PE Funds on the "legal list."

The following pages provide a more in-depth description and details of PE Funds and the IPA's recommendations with respect to the Department's proposal.

I. PE Funds Help to Achieve Retirement Investment Objectives

PE Funds are effective investments to help qualified investors achieve their retirement investment objectives. These products:

- Provide a Range of Strategic Investment Alternatives to Target Individual Retirement Plan Needs. PE Funds are not "one size fits all" products, but rather provide a broad range of risk and return attributes. This allows for the appropriate matching of investor needs and objectives with specific products' attributes, while at the same time providing the more universal portfolio benefits described below. The dimensions of PE Fund adaptability to individual retirement objectives includes: accessibility of alternative real estate asset classes (*e.g.*, land, office, industrial, retail, apartment, hotel/hospitality, self-storage, net-lease, and other specialty property types); alternative composition of primary investor returns running the spectrum from primarily income to primarily capital growth; a broad range risk-return attributes (*e.g.*, level of debt financing used to increase potential returns, stage of real property operations from under development to existing and fully leased), and length of capital commitment (*e.g.*, anticipated life of the individual PE Fund typically ranging from three to ten years).

[7] The descriptions of the PE Funds included in this comment letter are general in nature. Some individual PE Funds may vary from the examples described herein with respect to distribution method, structure, compensation arrangements, and regulatory framework. We believe, however, that they are most representative of the vast majority of existing PE Funds.

- <u>Provide Superior Income Distributions.</u> Depending on their primary objective, (*e.g.*, income or growth) PE Funds can provide a stable stream of income which can sustain lifestyle in retirement.

- <u>Provide the Potential for Inflation Protection</u>. Inflation is one of the most significant risks to retirement income and the purchasing power of savings. Unlike bond and fixed income portfolios where the purchasing power of invested capital can be eroded by inflation, the asset-based PE Funds can provide capital protection through appreciation of the value of the real estate assets they own. In addition, to the extent inflation induces increases in commercial property rents, the stream of operational income received by PE Fund investors can increase, providing another dimension of inflationary protection.

- <u>Avoid Exposure to the Volatility of Traded Securities Markets</u>. By investing directly in real properties, PE Funds help investors avoid concentrating their portfolios in exchange-traded securities or vehicles which invest in exchange-traded securities, and thereby help to reduce the volatility and market risks associated with such products in investor portfolios.

  Historically, this volatility in exchange-traded securities markets has tended to induce retail investors to sell securities at times of declining market prices and purchase securities at times of increasing market prices, as demonstrated in Morningstar's Investor Return metric. Although such potential volatility goes hand-in-hand with the benefit of total liquidity, as described below, achieving the diversification benefit of low correlation requires including less liquid investments in retirement portfolios.

  Volatility can be particularly detrimental to retirement investors whose retirement portfolios are concentrated in exchange-traded securities and products and who have begun regular withdrawals to sustain their lifestyles. For these investors, when the value of their portfolio has been temporarily depressed due to market volatility while still needing to take distributions to sustain their lifestyle, such distributions will represent a greater proportion of their retirement savings, thereby reducing the future income-generating potential of their retirement savings, and compromising their lifestyles.

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- Enable the Assembly of More Effectively Diversified, and Therefore More Stable, Investment Portfolios by Retirees. PE Funds are a crucial component of a wise retirement, estate and generational planning strategy because they are composed of real assets (*i.e.*, land and commercial real estate) whose returns tend to have low correlations with returns from exchange-traded securities and products comprised primarily of exchange-traded securities. PE Funds provide individual investors with access to professionally managed, commercial real estate ownership which for years has been a fundamental component of the investment portfolios of institutional pension plans and endowments. These institutional investors, operating under "prudent investing" principles, have long recognized the tenets of Modern Portfolio Theory. This theory, first described by the economist Harry Markowitz and subsequently confirmed through observation and quantitative analysis, states that investors can achieve superior risk-adjusted returns by combining assets that have different risk characteristics. This combining of assets can result in a portfolio with less risk than the individual assets comprising it, without sacrificing return potential. A key determinant of the amount of risk reduction is not just the number of assets combined, but more importantly their "correlation." Two asset classes whose returns move in parallel (*i.e.*, when one goes up, the other goes up) are said to have a positive correlation; if their returns move in opposite directions they have a negative correlation. Markowitz's great contribution to investors' wallets was his demonstration that anything less than perfect positive correlation can potentially reduce risk.[8]

  Because PE Funds invest directly in real properties rather than exchange-traded real estate securities, PE Funds provide retirement investors with the opportunity to diversify and stabilize their portfolios of exchange-traded investments, and thereby improve their risk/return profile in the same way professionally managed institutional pension and endowment plans diversify and stabilize their portfolios. These assets have historically shown low correlations with financial assets, and, therefore, are recognized as effective diversifiers.

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

II. Why PE Funds Should be Included on the Department's Proposed Asset List

If the Department does not abandon the "legal" Asset list approach in favor of a principles-based approach to its proposal, then the IPA submits that PE Funds belong on any such list for the following reasons:

- Optionality to Tailor Product Selection to Investment Objectives and Benefits Desired. As previously stated, PE Funds provide qualified investors with a variety of real estate product alternatives which can help achieve retirement investing objectives by providing current income, inflation protection and preservation of purchasing power, capital growth, reduced exposure to the negative consequences of traded market volatility, and a portfolio constructed in accordance with Modern Portfolio Theory and designed to pursue optimal risk-adjusted returns. While suitability requirements limit their use to a segment of the qualified investor pool, within this segment their use is extremely common.

- Finite Life. PE Funds do not have an active secondary market. This, however, does not mean that PE Funds are fully illiquid. Notably, there is a growing market for shares of PE Funds comprised of private equity funds that buy interests in other established funds, and there are certain segments of the market through which secondary sale liquidity is available. More importantly, PE Funds have limited lives (*e.g.*, typically three to ten years) and are comprised of multiple real estate asset investments that either may be sold individually during the life of the fund or at the end of its term. Investors typically receive cash distributions upon each realization event, providing a degree of interim liquidity and full liquidity at the end of the PE Fund's anticipated real estate holding period. However, the inherently illiquid nature of real properties dictates that any real estate investment vehicle designed to provide the portfolio benefits of diversification and low correlation with exchange-traded financial assets will by its nature have limited liquidity. So, retirement investors seeking an optimally diversified portfolio cannot achieve that objective without investing in non-listed securities or assets.

- Alignment of Interests with its Investors. Unlike many other investment products, where the fund manager determines the value of assets for purposes of calculating the management and performance fees during the operational stage of the investment, a PE Fund's manager receives its management fee based on a percentage of an investor's commitment to the

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fund during the anticipated investment period (ranging from 1% to 2%), rather than on an estimated value which has not been realized. Further, in a very limited number of programs, if the investment continues beyond the anticipated investment period, the PE Fund requires that this management fee decline to a lower percentage of remaining invested capital thereafter. Likewise, performance fees are based on the PE Fund's realized gains on each of its investments, and are not based on the unrealized increase in the value of the fund's investments.

Where performance fees in a PE Fund are calculated on an investment-by-investment basis, it is possible that, in the aggregate, the partnership's manager (the general partner) may receive a higher percentage of returns than would be determined based on the overall performance of the PE Fund (for example, if the interim property sales produce gains but the final liquidating property sale is at a loss which reduces the overall return from the PE Fund). Typically, such PE Funds include a mechanism that provides an additional investor safeguard to ensure that performance fees do not exceed the agreed-upon percentage of gains. This mechanism, often called a "clawback," requires the general partner to return previously paid performance fees to the investors to the extent they represent more than its agreed-upon profit split.

- Substantial Regulations. As is described in greater detail below, PE Funds, and those who sell them, are subject to considerable levels of regulation by the U.S. Securities and Exchange Commission ("SEC"), the Financial Industry Regulatory Authority ("FINRA"),[9] and the securities regulators of the states in which those products are sold. While the regulations differ to some degree, in general, the regulation of PE Funds addresses topics such as a broker-dealer's thorough, independent due diligence obligation to investors with respect to the PE Fund, disclosure requirements (*e.g.*, prepare and file a private placement memorandum or notice filing with FINRA), and the imposition of investor suitability standards (*e.g.*, a requirement that broker-dealers selling the products assess the suitability of the products for the investor).

- Professional Management Expertise. PE Funds are increasingly attracting "institutional quality" professional asset management companies with

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

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exceptional qualifications in the areas of their asset focus. Due to the real, tangible nature of a PE Fund's assets, its success demands the involvement of programmatic managers with significant experience in operating real estate assets.

- Commonality of Private Investment Vehicles. According to an SEC study, in 2012, private offerings of securities accounted for $1.7 trillion of new capital, while public offerings accounted for $1.2 trillion.[10] In this regard it is noteworthy that a 2015 study observed that: "Advised investors have more diversified portfolios, own twice as many asset classes, have more balanced portfolio asset allocations and use more packaged products for equity exposure compared with non-advised investors."[11] The IPA believes that this greater diversification of asset classes and products among advised investors reflects, in part, a significant use of private placement products such as PE Funds.

  The foregoing is especially notable when comparing the size of the private offering market to the size of the public offering market with respect to certain of the financial instruments that have been designated as "Assets" under the Proposed BIC Exemption. For example, in 2012, there were 32,989 private offerings which accounted for $903 billion in capital raised. During the same period, public debt, which is included as an "Asset" (*e.g.*, corporate bonds offered pursuant to a registration statement) accounted for 1,473 offerings and raised just under $1.0 trillion in new capital. To the extent that commonality was a factor in the Department's determination to include corporate bonds as an "Asset," privately offered instruments compare favorably with respect to commonality.[12]

III. PE Fund Structure and Purpose

A PE Fund is an investment vehicle that makes real estate-related investments, typically by acquiring and operating real estate assets in the spectrum from land to income-producing real estate. PE Funds provide a spectrum of product selection

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10 *See*, Vladimir Ivanov & Scott Bauguess, Securities and Exchange Commission, Division of Economic and Risk Analysis, *U.S. Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009-2012*, at 8 (July 2013), available at: https://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf.

11 *See*, Oliver Wyman, *The Role of Financial Advisors in the US Retirement Market* 11 (Jul. 10, 2015).

12 *Id.* at 9.

alternatives to enable investors to match the investment to their individual financial situations and objectives. The alternatives include the property type(s) which the PE Fund acquires (*e.g.*, office, industrial, retail, apartment, hotel/hospitality, self-storage, net-lease, other specialty land and property types); geographic location; degree of portfolio diversification (from having a single property focus to using a multi-property strategy); the composition of primary investor returns intended to be provided by the PE Fund (ranging from primarily income to primarily capital growth); risk-return attributes (*e.g.*, level of debt financing used by the PE Fund to acquire properties), and the stage (and therefore return potential) of real property operations ranging from under development to existing and fully leased.

Typically, but not exclusively, PE Fund investors commit to invest a certain amount of money over the life of the fund, and make their contributions in response to "capital calls" from the fund's general partner.[13] Because PE Funds typically do not retain a pool of uninvested capital, a capital call is made when a potential portfolio investment is identified. This process increases the rate of return which investors receive compared with a structure where the full amount of the commitment is made up-front. PE Funds are finite-life investments that typically intend to fully liquidate within three to ten years, as specified in the fund's offering documents. Depending on the objectives of the individual PE Fund, investors will typically receive cash distributions generated by the rental of the properties during the period of portfolio operations and then a final cash distribution when the properties are sold and the fund liquidates. However, where the PE Fund invests in multiple real property assets, investors may receive periodic cash distributions from realized investments and income received by the PE Fund.

IV. Existing Regulation of PE Funds

Interests in PE Funds are typically offered by means of private placements pursuant to an exemption from registration under the U.S. Securities Act of 1933 (the "1933 Act"[14]).[15] PE Funds typically rely on Rule 506(b) (and sometimes on Rule 506(c)

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13 *See*, *e.g.*, Staff Report to the Securities and Exchange Commission, *Implications of the Growth of Hedge Funds*, at 7-8 (Sept. 2003) (discussing and contrasting the structure and purpose of private equity funds versus hedge funds), available at: https://www.sec.gov/news/studies/hedgefunds0903.pdf.

14 *See, e.g.*, the 1933 Act, available at: http://www.sec.gov/about/laws/sa33.pdf.

15 Offers and sales of most PE Fund interests are exempted under Regulation D (17 C.F.R. § 230.501 et seq.). Regulation D calls for the electronic filing of Form D with the SEC no later than 15 calendar days after the "date of first sale" of their offerings and, in certain instances, periodically thereafter. Form D requires the names and addresses of the PE Fund's promoters, executive officers, and directors, and certain details about the offering. *See, e.g.*, Form D and instructions, available at: http://www.sec.gov/about/forms/formd.pdf.

starting September 23, 2013), of Regulation D for their private offering exemption under Section 4(a)(2) of the 1933 Act.[16] The Rule 506(b) exemption requires the fund to comply with the following standards: (a) the fund "cannot use general solicitation or advertising to market the securities", (b) the fund "may sell its securities to an unlimited number of 'accredited investors'[17] and up to 35 other purchasers", (c) "all non-accredited investors, either alone or with a purchaser representative, must be sophisticated—that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment", (d) the fund "must give non-accredited investors disclosure[18] documents that are generally the same as those used in registered offerings", (e) if the fund "provides information to accredited investors, it must make this information available to non-accredited investors as well", and (f) the fund "must be available to answer questions by prospective purchasers."[19]

The fund manager and the general partner of a PE Fund are often professional real estate management organizations or their affiliates, which, with respect to certain PE Funds, may be registered as "investment advisers" under the U.S. Investment Advisers Act of 1940 (the "Advisers Act").[20]

IMPORTANT NOTE: *The term "advisor" in the context of a PE Fund refers to the entity which manages and guides the daily operation of the fund. This entity is typically a company that specializes in the real estate asset class in which the fund invests and is compensated for its services as described herein. This manager of the entity should not be confused with the client-facing "financial advisor" who deals directly with the investor and provides information and makes recommendations with*

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16 *See, e.g.*, Rule 506 of Regulation D exemption of Section 4(a)(2) of the 1933 Act, available at: http://www.sec.gov/answers/rule506.htm.

17 Under Rule 506 of Regulation D, a PE Fund may sell its securities to what are known as "accredited investors." For example, investors can qualify as accredited investors if their "individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000." The term accredited investor is fully defined in Rule 501 of Regulation D, available at: http://www.ecfr.gov/cgi-bin/retrieveECFR?gp=&SID=8edfd12967d69c024485029d968ee737&r=SECTION&n=17y3.0.1.1.12.0.46.176.

18 *See, e.g.*, Rule 502 of Regulation D (setting forth disclosure and other conditions applicable to offers and sales made under Regulation D), available at: http://www.ecfr.gov/cgi-bin/retrieveECFR?gp=&SID=8edfd12967d69c024485029d968ee737&mc=true&n=pt17.3.230&r=PART&ty=HTML#se17.3.230_1502.

19 *See*, the SEC's discussion of Rule 506 of Regulation D, available at: http://www.sec.gov/answers/rule506.htm.

20 *See, e.g.*, the Advisers Act, available at: https://www.sec.gov/about/laws/iaa40.pdf.

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respect to investments. For purposes of clarity, the IPA will refer sometimes herein to the managers of PE Funds as the "External Manager" or "General Partner."

V. Distribution of PE Funds

A. The Typical Distribution Process for PE Funds

PE Funds are often distributed by broker-dealers that are registered with the SEC, FINRA, and the relevant state securities regulatory authorities. The broker-dealer personnel involved in sales activities ("registered representatives") are also regulated by the SEC, FINRA, and the applicable state regulatory authorities.[21] To a certain extent, investment advisers that are registered with the SEC and the relevant state regulatory bodies (or that are exempt from such registration) also advise clients with respect to investments in PE Funds.

Depending upon the size of the PE Fund offering, the process of distribution of the fund's securities may involve either a single registered broker-dealer or the formation of a selling group of registered broker-dealers. Unlike initial public offerings for exchange-traded securities, PE Funds typically conduct offerings of securities which may last from 6 to 28 months before closing the offering to new investors. Where a selling group is needed, it is formed by a dealer manager, which is a registered broker-dealer. As described below, each participating broker-dealer must conduct due diligence on the offering and an in-depth suitability analysis. Direct investor contact occurs between the registered representatives of the participating broker dealer(s) and their clients, and typically not at the dealer manager level or the External Manager/General Partner level.

Fees charged by broker-dealers relating to the distribution of PE Fund securities are generally one-time, up-front fees payable out of gross offering proceeds. These front-end fees include sales commissions, dealer manager fees, and bona fide due diligence expenses. These distribution costs for analogous publicly registered investment products (*e.g.*, publicly registered, non-listed real estate partnerships and real estate investment trusts ("REITs")) are limited by FINRA to 10% of the gross offering proceeds. Although

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21 Broker-dealers registering with the SEC must: (a) file SEC Form BD; (b) become a member of a self-regulatory organization (usually FINRA); (c) become a member of the Securities Investor Protection Corporation; (d) comply with all applicable state requirements; and (e) any "associated person" (*i.e.*, any partner, officer, director, branch manager, or employee of the broker-dealer) must satisfy applicable qualification requirements, including passing any required exams and participating in continuing education. *See, e.g.*, the SEC Guide to Broker-Dealer Registration; Registration and Regulation of Brokers and Dealers, Section 15 of the U.S. Securities Exchange Act of 1934, available at: http://www.sec.gov/divisions/marketreg/bdguide.htm.

no such regulatory limits apply to PE Funds, market forces in the broker-dealer community – in large part driven by a recognition of the cost limitations among analogous public products -- have tended to drive distribution costs for PE Funds down to public product levels.[22] The fact that these up-front fees in PE Funds are intended to defray the ongoing services of the broker-dealer and its registered representative, during the three to ten year life of the investment suggests that these fees compare favorably with the annual fees paid by investors to investment advisors based on assets under management for a portfolio comprised only of investments on the Department's proposed Asset list over a comparable multi-year holding period.

B. Federal Regulations Require Thorough Due Diligence and Disclosure in Connection with Offers and Sales of PE Funds

Broker-dealers, whether registered or not, are subject to federal and state securities regulations that are designed to protect investors from fraudulent or deceptive sales of securities. FINRA imposes upon broker-dealers the obligation to conduct a reasonable investigation of the issuer and the securities they recommend in privately placed offerings made pursuant to Regulation D.[23] As such, a broker-dealer has a duty, enforceable under federal securities laws and FINRA rules, to conduct a reasonable investigation of the PE Funds that it recommends. Moreover, any broker-dealer that recommends PE Funds offered under Regulation D must meet its suitability obligations under FINRA Rule 2310 (discussed below),[24] and must comply with the advertising, supervisory and record-keeping rules of FINRA and the SEC. These rules require that broker-dealers conduct due diligence on the products they offer, provide full disclosure, provide fair and balanced communications, and assess the suitability of the offered products, when dealing with investors. A broker-dealer's failure to comply with any of the foregoing may result in disciplinary actions, fines, and/or referrals to the SEC for the violation.[25]

FINRA describes a broker-dealer's duty to conduct reasonable due diligence when offering or selling a product offered under Regulation D, such as PE Funds, as follows:

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22 *See* the IPA Public Products Comment Letter for additional details regarding underwriting costs comparisons among public offerings.

23 *See, e.g.*, FINRA Regulatory Notice 10-22, available at: http://www.finra.org/industry/notices/10-22.

24 *See, e.g.*, FINRA Rule 2310, available at: http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8469.

25 *See*, *e.g.*, FINRA Sanctions Guidelines, available at: http://www.finra.org/sites/default/files/Sanctions_Guidelines.pdf.

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> A [broker-dealer] may not rely blindly upon the issuer for information concerning a company, nor may it rely on the information provided by the issuer and its counsel in lieu of conducting its own reasonable investigation. While [broker-dealers] are not expected to have the same knowledge as an issuer or its management, [they] are required to exercise a "high degree of care" in investigating and independently verifying issuer's representations and claims. Indeed, when an issuer seeks to finance a new speculative venture, [broker-dealers] must be particularly careful in verifying the issuer's obviously self-serving statements. The fact that a [broker-dealer's] customers may be sophisticated and knowledgeable does not obviate the duty to investigate. Moreover, in Regulation D offerings the SEC advises issuers to provide the same information to accredited investors as they are required to provide to non-accredited investors, in view of the antifraud provisions.[26]

Furthermore, FINRA sets forth criteria that a broker-dealer should investigate regarding the issuer and management of a PE Fund. For example, FINRA states that a broker-dealer should inquire into: (a) the success of past securities offerings by the issuer; (b) pending litigation with respect to the issuer or its affiliates; (c) any previous or potential regulatory or disciplinary problems of the issuer; and (d) the expertise of management for the issuer's business, among other things.[27] In fulfilling its due diligence obligations, a broker-dealer "may retain counsel or other experts."[28] FINRA requires that a broker-dealer verify the qualifications and competence of counsel or experts retained to perform an investigation, while bearing in mind that "the use of counsel or experts does not necessarily complete the broker-dealer's investigation responsibilities, insofar as a review of the counsel's or expert's report may identify issues or concerns that require further investigation."[29] In addition, FINRA imposes a duty

26 *See*, FINRA Regulatory Notice 10-22 (internal citations and quotations omitted).
27 *Id.*
28 *Id.*
29 *Id.*

upon the broker-dealer to maintain records of the process and results to "demonstrate that it has performed a reasonable investigation."[30]

Aside from conducting thorough due diligence of PE Funds and their issuers, broker-dealers must also comply with FINRA's filing requirements for private placements. FINRA Rule 5123[31] requires broker-dealers, selling privately placed products, such as PE Funds, in reliance on an available exemption from registration under the 1933 Act, to file any private placement memorandum, term sheet or other offering documents with FINRA within 15 days of the date of the first sale of securities, or indicate that there were no offering documents used.[32] Typically, private placement memoranda, which comply with Rule 502(b)(2) of Regulation D, contain relevant disclosures that allow an investor to weigh the risks involved with an investment and make a fully informed decision with respect to the investment.

C. Federal Regulations Require Consideration of the Investor's Best Interests

Federal law and FINRA rules require brokers to "adhere to high standards of conduct in their interactions with investors."[33] As a general matter, the suitability requirements of FINRA Rule 2111[34] and of FINRA Rule 2310[35] mandate that broker-dealers have a reasonable basis to believe that a recommended transaction or investment involving securities is suitable for each customer based on reasonable diligence[36] into the investor's investment profile. Broker-dealers must believe that the customer has the financial ability to meet the commitment of the investment. The suitability obligation

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30 *Id.*

31 *See, e.g.*, FINRA Rule 5123 (noting that certain filing exemptions apply, such as sales to investment companies or certain accredited investors, among others), available at: http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=10753.

32 *See, also*, Regulatory Notice 12-40 (discussing the requirements of FINRA Rule 5123), available at: http://finra.complinet.com/net_file_store/new_rulebooks/f/i/FINRANotice12_40.pdf.

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

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

35 *See, e.g.*, FINRA Rule 2310 and FINRA Regulatory Notice 10-22, available at: http://www.finra.org/industry/notices/10-22 and http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8469.

36 For example, broker-dealers have a duty "to conduct reasonable investigation of securities, including those sold in a Regulation D offering." *See*, *e.g.*, FINRA Regulatory Notice 10-22.

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requires that broker-dealers make an assessment of: (1) reasonable basis suitability, (2) customer-specific suitability, and (3) quantitative suitability.[37]

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

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

Quantitative suitability means the broker-dealer with actual or de facto control over a customer account must have a reasonable basis for believing that a series of recommended transactions (even if individually suitable) are not excessive or unsuitable in the aggregate in light of the customer's investment profile. FINRA enumerates several factors that might suggest excessive activity, such as turnover rate, cost-equity ratio, and the use of in-and-out trading in a customer's account.[38]

VI. PE Fund Fees and Expenses

The fees and expenses associated with PE Funds can be segregated into two distinct categories: (1) fees and expenses associated with the formation of the fund and the sale of its securities to qualified investors through financial intermediaries (referred to herein as "Offering and Organizational Costs"); and (2) fees and expenses associated with the management and operation of the fund and its assets (referred to herein as "External Management Costs"). The first category of fees and expenses include compensation to the broker-dealers, registered representatives and investment advisers who make investment recommendations to investors. The second category of fees and

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

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

expenses are paid exclusively to External Management or other third parties and are not related to the process of recommending investments to individual investors.

When evaluating the nature and level of fees and expenses for PE Funds, it is important to understand the overall structure of the management of the enterprise compared with the management of public non-listed and exchange-traded real estate investments (*e.g.*, REITs). REITs can be either internally or externally managed. Simply put, internally managed entities are operated by employees of the entity and the overall costs of management, including the salaries, benefits and incentive compensation of these employees, are subsumed into the entity's reported "general and administrative expense" reporting. In contrast, externally managed entities typically have no employees and instead contract with a separate company experienced in the asset class to provide management services and conduct the day-to-day operations of the entity. The costs of such external management are separately reported (typically categorized by the nature of the service provided – *e.g.*, acquisitions, asset management, property management, etc.) in financial statements as fees paid to the External Manager.

The determination of which management structure, internal or external, to use is made by the issuer. For real estate investment entities, which commence their existence by way of private offerings that have not yet raised capital nor made investments, external management structures are preferred. They avoid the challenge of attempting to attract an experienced management team and incur the associated full overhead expenses for a company which has not yet raised capital, acquired a portfolio, or generated revenues over which to spread such employment costs. Therefore, PE Funds are typically, but not exclusively, externally managed.

Separate and apart from the Offering and Organization Costs associated with the formation of the product and the private offering and issuance of interests in PE Funds (which include legal and accounting representation and printing of offering documents, among other expenses), there are a variety of fees and expenses charged in connection with operation of the PE Fund.

While not all PE Funds are subject to the same fees and expenses, which may vary depending on the specific activities of the PE Fund, examples of the types of fees and expenses payable by most PE Funds to the External Manager or other third-party service providers include: acquisition fees for the selection, evaluation, structuring, and purchase of real estate assets; the reimbursement of expenses incurred in connection with the selection, purchase, development, or construction of properties; an asset management fee based on a percentage of the cost or value of the PE Fund's assets; property management fees, oversight fees, and construction management fees; a financing

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coordination fee as a percentage of the amount of any original financing or refinancing coordinated by the External Manager; a service fee for the provision of administrative services to the PE Fund's investors; disposition fees rendered in connection with the sale of PE Fund assets; and performance and incentive fees (sometimes subject to a hurdle rate). As earlier noted, there are some conflict ameliorating factors relevant to certain of the aforementioned fees.[39] Further, as previously described, the fees described above as being paid to the External Manager of a PE Fund would typically be paid to the External Manager of an exchange-traded REIT or in the form of compensation, benefits and related overhead to employees of an internally managed exchange-traded REIT.

VII. Liquidity of PE Funds

PE Funds do not have an active secondary market. This, however, does not mean that PE Funds are fully illiquid. Notably, there is a growing market for shares of PE Funds comprised of private equity funds that buy interests in other established funds, and there are certain segments of the market through which secondary sale liquidity is available. As previously indicated, PE Funds have limited lives (*e.g.*, typically three to ten years) after which the real estate asset(s) are sold and the proceeds are distributed to investors. Where the PE Fund is comprised of multiple real estate asset investments, properties may be sold individually during the life of the fund or at the end of its term. Investors typically receive cash distributions upon each realization event, providing a degree of interim liquidity and full liquidity at the end of the PE Fund's anticipated real estate holding period.

The fact that PE Funds do not offer the full liquidity associated with products, such as mutual funds, is a critical reason why they should be included in retirement portfolios. As retirement accounts are generally designed for long-term holding, there is no reason why a less liquid investment would be *per se* improper. In fact, the lack of immediate liquidity discourages "churning" and "market timing" and further reduces the investments' correlation to the stock market, all enhanced features and characteristics of a long term, patient retirement planning perspective.

Further, the inherently illiquid nature of real properties dictates that any real estate investment vehicle designed to provide the portfolio benefits of diversification and low correlation with exchange-traded financial assets, whether it be an institutional separate account or comingled fund, or a PE Fund, will, by its nature have limited liquidity. So, retirement investors seeking an optimally diversified portfolio cannot achieve that

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39 *See*, section II.

objective using solely exchange-traded REITs or mutual funds which invest in exchange-traded REITs and real estate companies.

Finally, as previously observed, the potential portfolio volatility which, of necessity, accompanies portfolios of directly or indirectly owned exchange-traded securities, which, therefore, are subject to the vagaries of the traded markets, can force investors who are taking retirement plan distributions to effectively liquidate their investments at times of depressed market conditions, thereby jeopardizing the future income-generating potential of their retirement savings and compromising their lifestyles.

VIII. Additional Bases for the Department to Include PE Funds in the Exemption

A. The Department Should Discard the Legal List of "Assets"

A list of "Assets" will deprive investors of choice and will render the Department unable to easily adapt to market changes. New investment products are continually introduced to the market. It is not feasible to expect that the Department will have the means or ability to regularly and continually consider and analyze new investment products for inclusion as an Asset. As a result, the Asset list process will create a category of investors who are not able to take advantage of market evolutions and improvements. Further, this will result in those investors being precluded from seeking the same return available to other investors or from being able to diversify their investment portfolios on the same basis as other investors. This outcome could both lower returns and increase risk through lack of portfolio diversification—the exact opposite of the Department's objectives.

Some of the emerging products supported by the IPA demonstrate this precise principle. PE Funds, for instance, share many of the same structural qualities as -exchange-listed real estate investment trusts, but have not yet captured the same level of market interest. IPA believes that it is only a question of time and that a list of approved "Assets" would effectively hamper the development of this product. Given the evolution of various investment products over the past decades, placing artificial restrictions on what options are open to IRA investors seems designed to tamp down market growth and limit options for investors. Further chilling the availability of licensed, regulated, and supervised professional advice to these very investors is facially inconsistent with the Department's goals.

In the Proposed BIC Exemption, the Department emphasized that it intended to adopt a "principles-based" or "standards-based" approach that "would flexibly accommodate a wide range of current business practices" while minimizing conflicts of interest.[40] Yet while the Proposed BIC Exemption is designed to accommodate a wide range of compensation, and to be adaptable over time to market changes in the way investment advisers are compensated, the Department abandoned a principles-based approach when it came to the types of assets covered by the exemption. By proposing a fixed list of acceptable "Assets," the Department chose to freeze in time the types of investments that may be offered to retail retirement investors. We urge the Department to reconsider the "legal list" approach, which is inconsistent with the history of ERISA and modern trust law. We urge the Department instead to adopt a flexible, principles-based approach to the types of assets to which the BIC Exemption applies and to allow retail retirement investors to continue to invest in PE Funds.

Until the early 1940s, many states required trustees to select investments from a statutory list of supposedly safe investments (a so-called "legal list"). Painful experience from the Great Depression showed, however, that virtually no investment is immune from risk, and that even the safest bonds and traditional investments could become worthless.[41] Legal lists failed to adapt to changing economic and business conditions, and reflected the since-discredited assumption that past performance is a reliable predictor of risk. As a result, the legal lists tended to prohibit relatively safe investments in companies with an arguably risky past but a stable future, while permitting investment in more risky companies with a stable past but risky future. This history led the drafters of Restatement (Third) of Trusts to conclude that "knowledge, practices, and experience in the modern investment world have demonstrated that arbitrary restrictions on trust investments are unwarranted and often counterproductive."[42]

The modern trend of fiduciary investment principles was driven in part by dissatisfaction with poor investment performance in legal list jurisdictions, and in part by a large body of academic research that resulted in what is known as modern portfolio

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40 Proposed BIC Exemption, 80 Fed. Reg. 21961.

41 *See*, *e.g.*, Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, 27 Real Prop. Prob. & Tr. J. 407 (1992) (summary of the background, development,t and criticism of traditional trust doctrine regarding investments, plus an overview of modern portfolio theory and other modern developments, from the Reporter for the Restatement (Third) of Trusts); H. Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, 76 Columbia L. Rev. 721 (1976) (describing the disastrous performance of "legal list" portfolios during the Great Depression in comparison to more flexible prudent man jurisdictions).

42 Restatement (Third) of Trusts, Ch. 17, Investment of Trust Funds (Introductory Note, Edward C. Halbach, Jr., Reporter); *see, also*, Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, *supra*; Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U.L. Rev. 52 (1987); B. Longstreth, *Modern Investment Management and the Prudent Man Rule* (1986).

theory.[43] Modern portfolio theory demonstrates that portfolios of risky (*i.e.*, more volatile) stocks can be combined in such a way that the portfolio as a whole could be less risky than the individual stocks in it.[44]

ERISA was the first legislation to apply modern portfolio theory to fiduciary standards of investment, and has been an influential landmark in the development of modern fiduciary law.[45] The Department can justifiably be proud of the leading role ERISA has played in applying flexible and modern principles to the investment duties of fiduciaries. In this regard, perhaps the most significant development beyond the adoption of ERISA itself was the express reliance on modern portfolio theory in the final regulations under Section 404 of ERISA:

> [I]t is the Department's view that an investment reasonably designed—as part of the portfolio—to further the purposes of the plan, and that is made upon appropriate consideration of the surrounding facts and circumstances, should not be deemed to be imprudent merely because the investment, standing alone, would have, for example, a relatively high degree of risk . . . . Accordingly . . . "appropriate consideration" shall include a determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio for which the fiduciary is responsible, to further the purposes of the plan, taking into account the risk of loss

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43 *See*, *e.g.*, Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, *supra*; H. Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, *supra*; John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, Yale Law School Faculty Scholarship Series (1976); John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law II*, Yale Law School Faculty Scholarship Series, Part I (1977) (describing the evolution of trust law, evidence for the notion that modern investment theory may be superior to conventional trust investment structures and has served as evidentiary backing for modern reforms in trust law and the investment duties).

44 A good general discussion of modern portfolio theory can be found in Burton G. Malkiel, *A Random Walk Down Wall Street*, Ch. 8 (9th edition 2007).

45 *See*, W. Brantley Phillips, Jr., *Chasing Down the Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts*, 54 Wash. & Lee L. Rev. 335 (1997) (describing how the passage of ERISA prompted the modernization effort of the third Restatement and uniform state laws on prudent investment); Samuel D. Cheris, *Making Responsible Investment Decisions in Light of the Prudent Person Rule*, 14 Est. Plan. 338 (1987) (describing how Congress adopted ERISA after hearing extensive testimony to the effect that traditional interpretations of prudence were too restrictive when applied to employee benefit plans).

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> and opportunity for gain (or other return) associated with the investment or investment course of action.[46]

Most important to the present discussion, the Department emphasized that its approach to prudent investing reflected a conscious decision to depart from legal lists and other traditional, restrictive applications of trust law:

> [T]he Department does not consider it appropriate to include in the regulation any list of investments, classes of investment, or investment techniques that might be permissive under the "prudence" rule. No such list could be complete; moreover, the Department does not intend to create or suggest a "legal list" of investments for plan fiduciaries.
>
> The preamble to the proposed regulation stated (as does this preamble) that the risk level of an investment does not alone make the investment *per se* prudent or *per se* imprudent.[47]

The impartial conduct standards embodied in the BIC Exemption were designed to mirror the ERISA duty of prudence, combined with the duty of loyalty.[48] It would be a mistake (and more than a bit ironic) to require broker-dealers in the retail retirement market to adhere to ERISA's standard of prudence while at the same time preventing them from considering investment products which, under the Department's own prudence regulations, they may be required to take into account in serving the best interests of their customers. Moreover, the Department's list would invariably – and in all likelihood quickly – suffer the same fate as the legal lists of the past, falling behind ever-changing market conditions, failing to adapt to new products and advances in knowledge, and consequently relegating the BIC Exemption to the margins of the retail marketplace:

> Trust investment law should reflect and accommodate current knowledge and concepts. It should also avoid

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46 44 Fed. Reg. 31639 (June 1, 1979), reprinted in CCH, Pension and Employee Benefits, Vol. 3, par. 24,038 (2015) (footnote omitted).

47 *Id.*

48 Proposed BIC Exemption, 80 Fed. Reg. 21970.

repeating the mistake of freezing its rules against future learning and developments.[49]

However, the "Assets" list does exactly the opposite. It explicitly does act to create by regulation a list of investments that are or are not appropriate. The list places the Department in the position of weighing which investments represent a suitable level of risk and which ones do not, as well as dictating the limits by which certain investors can access investment products in order to diversify their portfolios.

Finally, we would like to point out that in the preamble to the BIC Exemption, the Department said that it expects the best interest standard to be interpreted by courts in light of forty years of judicial experience with ERISA's fiduciary standards.[50] However, if the Department insists on inserting a legal list into the BIC Exemption, and thereby departing from a core principle of ERISA, it would virtually assure that interpretation of the best interest standard will diverge over time from otherwise applicable ERISA fiduciary standards.

B. If the Department maintains the "legal list" it should add the Real Estate Private Equity Funds to that list.

If the Department determines that a return to the "legal lists" of the past best serves the purposes of the Regulation and the BIC Exemption, IPA respectfully requests that the Department include the PE Funds on that list. As noted above, PE Funds are common, indeed ubiquitous, in the retirement investment marketplace and commonly included in many investor portfolios, providing access to investment opportunities once only available to wealthy investors, as well as diversification and protection against market volatility. To accomplish IPA's request in the most clear manner possible, IPA suggests that the list of "Assets" be amended to include "privately placed real estate private equity funds."

The other terms and conditions of the BIC Exemption are already robust and flexible enough to protect retail investors, regardless of the product type. For example, if a recommended investment has different characteristics than "Assets" on the current list – such as less liquidity, lack of a public market, or different fee structure – those characteristics would have to be disclosed and taken into account by the adviser in order to the meet ERISA's fiduciary obligations, and the stringent best interest standard and

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49 Restatement (Third) of Trusts, Ch. 17, Investment of Trust Funds (Introductory Note, Edward C. Halbach, Jr., Reporter).

50 Proposed BIC Exemption, 80 Fed. Reg. 21970.

other conditions of the BIC Exemption. Certainly, not all investments would be in the best interest of all retail investors, but the investment adviser's newly imposed fiduciary status combined with the conditions of the exemption already require the adviser to consider those factors before making a recommendation. Since the conditions of the exemption are both flexible and demanding, the Department need not attempt to determine in advance which assets are appropriate to particular retirement investors, or under what circumstances.

Moreover, the definition of "Adviser" in the exemption already requires compliance with applicable federal and state securities laws and licensing requirements with respect to the covered transaction. Thus, for example, any additional disclosure requirements or suitability standards of FINRA or other regulatory authorities with respect to PE Funds are effectively incorporated into the BIC Exemption.[51] Consequently, the exemption is flexible enough to accommodate different types of investments on the "Asset" legal list. At a minimum this should favor the inclusion of PE Funds on the legal list.

A comparison of some of the items on the list of "Assets" with the PE Funds illustrates some of the deficiencies of relying on a pre-established list of products, as opposed to providing a list of factors (and perhaps some baseline criteria) that industry participants can take into account in deciding for themselves whether a product complies with their fiduciary duties under the BIC Exemption and Conflict of Interest Rule. While the Department has expressed some concern about the liquidity of retirement investments, it has nevertheless included products on the legal list which impose penalties if the investor wishes to exit the investment early. To the extent that externally managed PE Funds invest in securities, their fund managers are subject to the fiduciary duties imposed upon investment advisers under the Advisers Act. Like any of the "Assets" that are sold by a broker-dealer or investment adviser (as defined by the Advisers Act), including corporate bonds, exchange traded funds and interests in registered investment companies, those selling the PE Funds are also subject to the basic FINRA-imposed suitability and disclosure requirements (in the case of brokers)[52] or the Advisers Act-imposed fiduciary standards (in the case of investment advisers). Any justification or authority the Department has for including some investment products as "Assets" while excluding others, such as the PE Funds, is far from clear.

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51 *See, e.g.*, FINRA Rule 2111 and Rule 2310, discussed above at section V. B. and C.

52 Of course, broker-dealers selling certain of the financial products currently included as "Assets" may be subject to additional federal and state regulatory obligations.

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IX. Other Suggestions to Make the BIC Exemption More Workable

A. The Department should reconcile its use of "best interest" with the existing guidance regarding ERISA's fiduciary obligations in order to avoid inconsistent and confusing interpretations.

In the preamble to the Conflict of Interest Rule, the Department states that the best interest standard "is not intended to add to or expand the ERISA section 404 standards of prudence and loyalty as they apply to the provision of investment advice to ERISA covered plans", but is instead intended to apply existing ERISA standards of prudence and loyalty to the IRA market.[53] Similarly, the preamble to the Proposed BIC Exemption provides that the best interest standard is intended to mirror the ERISA duty of prudence, combined with the duty of loyalty.[54] Yet the language of the best interest standard does not exactly mirror the standards of prudence and loyalty from ERISA section 404. While we understand that the Department believes that its departures from a literal blending of the duties of prudence and loyalty are simply uncontroversial glosses on those duties under existing law, it is not reasonable to expect that the differences in language between ERISA section 404 and the best interest standard will not lead to different meanings in the hands of courts and litigants. Accordingly, if the Department truly intends for the best interest standard to mirror the duties of prudence and loyalty under ERISA, it should do so directly by using the same words, or through a cross reference to the duties of loyalty and prudence under ERISA. Any additional explanatory gloss, such as "based on investment objectives, risk tolerance, financial circumstances and needs" of the investor, and "without regard to the financial or other interests" of the adviser and related parties, should be covered in the preamble or through examples, rather than in the text of the best interest standard itself.

B. The Department should clarify the use of typical revenue sharing payments.

The preamble to the Proposed BIC Exemption states that the Department intends for the BIC Exemption to facilitate the continued use of types of fees and compensation common in the retail market, including brokerage commissions, 12b-1 fees, and revenue sharing payments. One of the conditions of the exemption is that a financial institution's policies and procedures must not authorize compensation or incentive systems that would tend to encourage individual advisers to make recommendations that are not in the best interest of retirement investors. The final BIC Exemption should make clear – through

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53 Proposed Conflict of Interest Rule, 80 Fed. Reg. 21938.
54 Proposed BIC Exemption, 80 Fed. Reg. 21970.

safe harbors or examples – that such common forms of compensation, by themselves, do not "tend to encourage" advisers to make recommendations that are not in the best interest of investors or otherwise fail to meet the best interest standard.

C. The Department should re-evaluate the timing of the contract requirement between investor and investment adviser.

We are also concerned that the requirement that the adviser enter into a written contract with the retirement investor *prior to* making a recommendation is impractical. Given the breadth of the concept of a "recommendation" under the Conflict of Interest Rule, advisers may be unwilling even to talk to a retirement investor without first requiring the potential investor to sign a written contract. Prospective investors may well be intimidated or generally put off by an adviser requiring them to sign a detailed contract at the beginning of their first conversation.

Moreover, the prior-to requirement could encourage some advisers to preface their introductory conversations by stating that they are speaking to the investor only with respect to her non-IRA or non-plan accounts, bringing out the contract only if the investor later says she wants to invest from her IRA. Either way, the prior-to rule leads to unintended results.

We believe that the written contract requirement should be revised to require a written contract prior to the receipt of any compensation to which the BIC Exemption is intended to apply. In that way, if the contract satisfying the exemption isn't in place before the compensation is received, the compensation would not be covered by the exemption. But advisers and potential investors would be free to have preliminary conversations without the need for a written contract. This would also eliminate any confusion about when the adviser is providing advice and when she may just be providing investment education that does not require the adoption of fiduciary status.

D. The Department should expand the "seller's carve-out" to include sophisticated IRA and 401(k) plan investors.

The rationale for providing a seller's carve-out for large plans in the Conflict of Interest Rule should be extended to sophisticated plan participants and IRA owners. A participant or IRA owner with a large balance, or with substantial assets or income, should be able to understand after basic disclosure that a broker or other sales representative is selling a product, and that there is no reasonable expectation of a fiduciary relationship. At some level of account balance or other measure of sophistication, a plan participant or IRA owner should – subject to similar disclosure obligations – be treated the same as a large plan for purposes of a carve-out from the Conflict of Interest Rule.

Conclusion

PE Funds are an investment category which can provide important benefits to retirement plan investors, including income, inflation protection and capital growth to preserve the purchasing power of savings during retirement. The conceptual basis of PE Fund investing resides in Modern Portfolio Theory and derives from the historically low correlation between directly owned real estate assets and exchange-traded securities. PE Funds provide individual investors with access to the same diversification strategy used by the nation's leading public and private pension and endowment plans to increase risk-adjusted returns from retirement portfolios. As an investment category, PE Funds provide a range of strategic real estate investment strategies to address the needs and objectives of individual retirement plans, and are a commonly used tool in the portfolios of accredited investors.

The controls and requirements imposed upon those who distribute PE Funds and upon the products themselves (*e.g.*, SEC and FINRA guideline requirements as to the suitability, disclosure, and due diligence of both the offering and the issuer) provide a high standard of investor protection. Importantly, existing regulations already limit PE Fund investing to accredited investors and those with the financial sophistication and experience to evaluate the risks and merits of any individual PE Fund.

PE Funds provide liquidity via a finite holding period, at the end of which the true value of the investment is realized by all investors in the PE Fund. Limited interim liquidity is a necessary attribute of investing in real properties, an asset class which is inherently illiquid. Yet, such relative illiquidity is necessary to provide the portfolio benefits of diversification and low correlation with exchange-traded financial assets. An optimally diversified retirement portfolio cannot be constructed using solely exchange-traded REITs or mutual funds which invest in exchange-traded REITs. Including PE Funds or other forms of direct real estate investment in a portfolio of exchange-traded financial assets constitutes "prudent" investing, and the definition of "Assets" should not deny accredited investors access to these commonly used funds.

For all of the reasons set forth above, the IPA urges the Department to revise the Proposed BIC Exemption in order to include PE Funds within the scope of the BIC Exemption either by doing away with a legal list of "Assets" or by adding the PE Funds, as defined above, to that list. We appreciate your time and attention in ensuring that

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retirement investors are provided with the broadest array of investment options, while taking all reasonable measures to avoid conflicted advice.

Respectfully submitted,

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