

COMPLIANCE WATCH: Unlisted REITs Draw Scrutiny From Finra

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NEW YORK (Dow Jones)--Regulators' newly signaled concern over sales of non-traded and private real-estate investment trusts, or REITs, may be focused on dealings with seniors and with disclosure of just how illiquid these instruments are.

The Financial Industry Regulatory Authority, or Finra, is conducting a sweep of broker-dealer sales and promotion practices related to non-exchange-traded and private REITs, according to industry sources. Both instruments are sometimes also called unlisted REITs.

Finra, in a letter dated March 20, requests information such as sales figures, incentive payout schedules for registered representatives, blank customer applications and risk-monitoring reports. It gave broker dealers until April 13 to respond.

Tim Pedregon, a Dallas compliance consultant and former examiner for Finra, says the regulator is likely concerned about how these types of REITs are marketed to seniors. Private REITs, in particular, often rely on Regulation D, an SEC regulation that provides an exemption to registration. But the securities can be marketed and sold only to certain types of investors - usually those earning more than \$200,000 annually and who have a minimum \$1 million net worth including houses.

Declining real-estate values could mean that some investors, particularly seniors on fixed incomes whose net worth falls below \$1 million, are no longer considered qualified for certain investments.

Securities-arbitration attorneys say many investors in non-traded REITs don't understand - or aren't told - that the securities are illiquid. Some commissions on the securities are as high as 7%, according to Philip M. Aidikoff, a securities-arbitration attorney in Beverly

Hills, Calif.

Non-exchange-traded REITs are registered with the Securities and Exchange Commission but don't trade on national stock exchanges. Private REITs are similar, but aren't registered with the SEC.

Ron Kuykendall, a spokesman for the National Association of Real Estate Investment Trusts, or Nareit, a trade group, says non-traded and private REITs appeal to many institutional and high-net-worth investors because they don't fluctuate with market volatility, unlike publicly traded REITs, whose daily changing values are known to investors.

The securities often restrict redemptions by investors for the first 12 to 18 months. Kuykendall says the time frame helps accumulate a fund that trust managers use to buy real estate.

Other restrictions are common. For example, some investments allow only quarterly redemptions. And some non-exchange-traded REITs can deny redemption requests if too many investors want to redeem at once, says Lawrence L. Klayman, a securities-arbitration lawyer in Boca Raton, Fla., who represents investors.

Randall C. Place, an attorney in Southern Pines, N.C., says he is aware of a case where a broker recommended non-traded REITs to an investor but didn't explain that they were illiquid. The problem became apparent only when the investor tried to liquidate his portfolio. The investor is now trying to recover the value of the illiquid funds, Place says.

Klayman says the securities, while non-traded, could be easily affected by declines in real-estate values. That could prompt many investors to request redemptions at once, he says.

Steven B. Caruso, a New York-based securities attorney, says non-exchange-traded and private REITs remind him of the limited partnerships marketed by Prudential Securities and Payne Webber during the late 1980s and early 1990s.

The investments were marketed as safe but turned out to be risky and illiquid, resulting in a spate of regulatory enforcement cases.

Valuation is also a concern, says Caruso: The same security purchased through different brokerages can have different values. Finra issued valuation guidance to brokerages about non-exchange-traded and private REITs in February.

Because the securities trade privately, the size of the market and the level of interest among current investors are murky. SecondMarket, a New York-based marketplace for illiquid assets, has noticed a "smattering of interest" in recent months from investors interested in selling unlisted REITs, according to Jeremy Smith, chief strategy officer. The company doesn't currently offer a marketplace for unlisted REITs, he says.

Aidikoff, who recently settled several claims brought by investors involving nontraded REITs, describes them as having a potential for abuse.

"From the perspective of a normal retail customer, I can't imagine why anyone would buy them," he says.

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