A Primer on Non-Traded REITs and other Alternative Real Estate Investments

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In this paper we provide a brief overview of the ways to achieve real estate exposure and focus our analysis on alternative real estate investments. The term alternative real estate investment, as used in this paper, refers to real estate securities such as non-traded Real Estate Investment Trusts (REITs), private REITs, and Tenants-in-Common (TICs), which are often sold to but may be unsuitable for most retail investors. Some common problems of alternative real estate investments are: 1) their illiquid nature allows them to give investors an illusory sense of low price volatility, 2) their high fees and significant conflicts of interests may lead to a loss of shareholder value, and 3) their reliance on leverage to fund current dividend payments may hide their inability to pay future dividends. Limitations on publicly-available data oblige us to concentrate much of our discussion on non-traded REITs. Our analysis is relevant for the even less transparent private placement REIT and TIC market.

I. Introduction

Many retail investors add real estate exposure to their portfolios despite already having a leveraged and undiversified real estate investment in their own home. What, if any, additional real estate exposure is suitable for investors depends on the extent to which alternative real estate investments are plagued by high costs, risks and illiquidity.

Investing directly in real estate often requires substantial capital or leverage to purchase even a single property and such investments are by nature undiversified, either by type (office, retail, residential, etc.) or region. Common stock in somepublicly traded companies – construction companies, hotel chains, mortgage service firms, and many others – include significant indirect real estate exposure and can fluctuate in value along with trends in broad real estate markets.

Investments in real estate-related common stock have the advantages of being sufficiently divisible to permit relatively small investments and being thoroughly liquid,

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continuously priced, and extensively covered by market analysts. For example, an investment in homebuilders' common stock provides substantial real estate exposure. However, indirect real estate exposure through the common stock of publicly traded companies includes the idiosyncratic risk of that firm's operations or business model. Some of these risks may be avoided by focused real estate investment.

Focused real estate investments are sold by investment companies including open-end funds, closed-end funds, exchange-traded funds, and unit investment trusts. Securities offered by investment companies are highly regulated. In addition to being subject to the same securities laws that apply to other publicly offered securities (Securities Act of 1933 and Securities Act of 1934), they are regulated by the Investment Company Act of 1940, which means that investment companies must make periodic disclosures regarding their investment objectives, company structure, operations, and other matters.

Traded and non-traded REITs are registered with the SEC and are subject to the Securities Act of 1933 and 1934; hence, like other publicly offered securities they must make public a prospectus of the securities for sale, as well as regular financial statements of the issuer and information on the issuer's management. Traded REITs trade on an exchange and can be bought or sold through a brokerage firm. Non-traded REITs are registered with the SEC but their shares are not listed on an exchange; their shares are illiquid and difficult to value. Investors can typically only sell their shares after a holding period of a year and under a limited repurchase program.

Private REITs and TICs are not registered with the SEC but are sold through private placement offerings under Rule 506 of the SEC's Regulation D. Only investors who meet certain criteria can invest in private placement offerings. In general, individual investors with over $1 million in net worth or an income exceeding $200,000 in each of the two years before their purchase of the security satisfy the eligibility criteria.[2] Alternatively, private REITs and TICs may be offered pursuant to the small-issue registration exemptions in Rules 504 and 505, with each rule differing in limits on offering size or number of investors that are allowed to purchase the security.[3]

In this paper we assess the suitability of alternative real estate investments: non-traded or private REITs and Tenants-in-Common (TICs) for retail investors. After discussing whether investors typically need additional real estate exposure and providing

[2] Securities and Exchange Commission, General Rules and Regulations promulgated under the Securities Act of 1933, Regulation D, 17 C.F.R. Section 230.5801-230.508 (2007) from <http://taft.law.uc.edu/CCL/33ActRls/regD.html> [accessed 11 January 2012].

[3] Ibid, Rules 504 and 505.

a more detailed description of traditional forms of real estate exposure, we review the history of alternative real estate investments and describe their main characteristics.

Our examples use non-traded REITs because publicly available offering documents and data for private placement REITs and TICs are limited. For example, we point out that the posted share price of non-traded REITs are routinely kept at its initial offering price regardless of changes in the true value of the underlying real estate portfolio. This lack of mark-to-market transparency permeates the private placement REIT and TIC markets and allows deceptive releases of information from sponsors, issuers and brokers. For example, often a substantial portion of the high dividends used to market these investments comes from cash reserves or new debt financing rather than operating income. While such deception might have little consequence in a market for thickly traded securities, it leads to real harm in the non-traded and private placement REIT and TIC markets. Substantial conflicts of interest in these alternative real estate investments, combined with their significant illiquidity, make these seemingly conservative securities unsuitable for retail investors.

II. Do Retail Investors Really Need More Real Estate Exposure?

Institutional investors' allocations and published literature provide useful guidelines on the level of appropriate real estate exposure for the typical investor. Pennachi and Rastad (2011) find that U.S. state and local government pension funds allocated an average of 3.1% to 6.5% of their total portfolio to U.S. real estate from 2000 to 2009 125.[4] Their findings are in line with recent asset allocation guidelines as well as a review of the asset allocation strategies of pension funds published by J.P. Morgan.[5]

The academic literature finds that because a person may derive some benefit from living in a home that he owns as opposed to renting, the consumption benefits of owner-occupied housing may lead consumers to overinvest in real estate.[6] Empirical literature shows that real estate housing stocks are generally unattractive except for investors

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[4] Pennachi, George and Mahdi Rastad (2011), "Portfolio Allocation for Public Pension Funds," *Journal of Pension Economics and Finance*, Vol. 10, pp. 221-245.

[5] See J.P.Morgan, Public Pension Funds: Asset Allocation Strategies available at <www.jpmorgan.com/tss/General/Public_Pension_Funds_Asset_Allocation_Strategies/1289431691010> [accessed 15 March 2012] and FRS Pension Plan Asset Allocation Policy, 27 September 2011 Estimating Conference, available at <http://edr.state.fl.us/content/conferences/actuarial/ActuarialEstimatingConfPresentation.pdf> [accessed 15 March 2012].

[6] Brueckner, Jan (1997), "Consumption and Investment Motives and the Portfolio Choices of Homeowners," *Journal of Real Estate Finance and Economics*, Vol. 15, No. 2, 159-180.

seeking a high risk/high return portfolio.[7] Nevertheless, the reported close-to-zero or negative correlation between investment in residential real estate and other asset classes, such as stocks, bonds and T-bills may result in high net-worth individuals benefiting from additional real estate exposure beyond that provided by their homes.[8]

III. There are Many Ways to Invest in Real Estate.

Error! Reference source not found. lists major ways investors can obtain focused real estate exposure.

Table 1: Types of Real Estate Investment

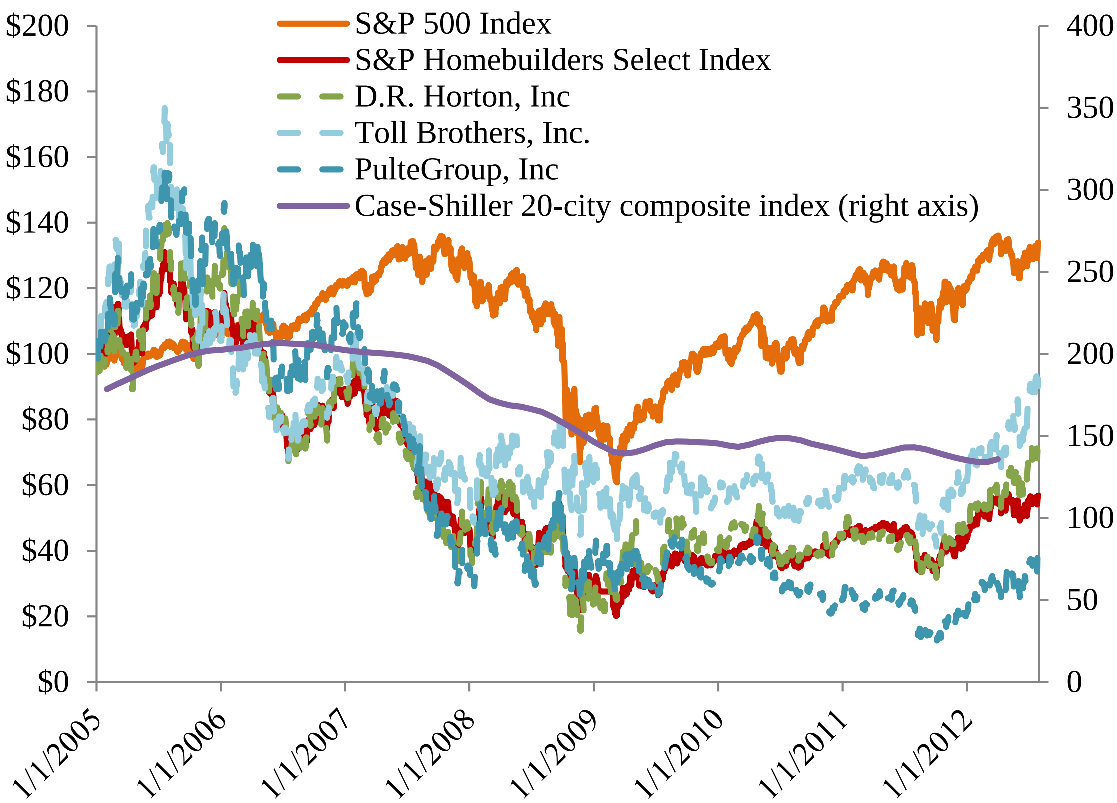
Category	Examples
Homebuilders' common stock	D.R. Horton, Inc. (DHI) Toll Brothers, Inc. (TOL) PulteGroup, Inc (PHM)
Open-End Funds	Vanguard REIT Index (VGSIX) Nuveen Real Estate Securities (FREAX) Fidelity Real Estate Investment Portfolio (FRESX)
Closed-End Funds	Cohen & Steers Quality Income Realty (RQI) CBRE Clarion Global Real Estate Income (IGR) Nuveen Real Estate Income Fund (JRS)
Unit Investment Trusts	First Trust 1561 REIT Growth (FRGINX) First Trust 1871 REIT Growth (FGROMX) First Trust 2060 REIT Growth (FRPLJX)
Exchange Traded Funds	Vanguard REIT ETF (VNQ) iShares Dow Jones Real Estate Index Fund (IYR) iShares Cohen & Steers Realty Majors Index Fund (ICF)
Traded REITs	Simon Property Group (SPG) American Tower Corporation (AMT) Public Storage (PSA)
Non-traded REITs	Apple REIT Six-Ten, Behringer Harvard Opportunity REITs I-II, Hines Global REIT
Private REITs	Wells Limited Partnerships, Rancon Realty Fund, Lightstone Value Plus
TICs	DBSI Amarillo Apartments LLC AEI Fund Management XVII Inc

[7] Englund, Peter, Min Hwang , and John Quigley, "Hedging Housing Risk," *Journal of Real Estate Finance and Economics*, 24:1/2, pp.167-200.
[8] Goetzmann, William (1993), "The Single Family Home in the Investment Portfolio," *Journal of Real Estate Finance and Economics*, Vol. 6, pp. 201-222; Englund, Peter et al, *Op. Cit*.; Goodman, Jack (2003) "Homeownership and Investment in Real Estate Stocks," *Journal of Real Estate Portfolio Management*, Vol. 9, No. 2, pp. 93-105.

A. Investing in Homebuilders' Common Stock to Achieve Real Estate Exposure.

Exposure to the real estate market may be achieved through investing in homebuilders' common stock. Figure 1 plots the value of $100 invested in the common stock each of three large homebuilders, D. R. Horton, Inc., Toll Brothers, Inc., and PulteGroup, Inc. made on January 1, 2005. Figure 1 also plots the value of the S&P 500 Index and the S&P Homebuilders Select Index anchored to $100 on January 1, 2005. The right axis of Figure 1 measures the monthly Case-Shiller 20-city composite index, which is an average of single-family home prices in 20 metropolitan areas in the United States. The returns to investments in the homebuilders' common do not track the S&P 500 Index but do appear to follow home prices.

Figure 1: Comparison of the performance of the common stock of DR Horton, Toll Brothers, and PulteGroup to the S&P Homebuilders Select Index, the S&P 500 Index, and the Case-Shiller 20-city composite index



B. Open-End Funds are Liquid, Large and Professionally Managed.

Investing in homebuilders' common stock exposes investors to undiversified firm-specific risk. Investing in broader real estate portfolios may provide diversification benefits.

Traditional "open-end" mutual funds are a simple way for investors to purchase diversified real estate exposure. Mutual fund portfolios are managed by registered investment advisers. Shares in the funds are bought from a mutual fund company and sold back to the mutual fund company directly from the Fund or through a Fund's broker at the end of the business day and at their net asset value.

Real estate mutual funds, as other types of investment companies focused on real estate, typically invest in traded REITs.[9] At the time of writing there were 105 open-end funds with over 90% of their portfolio in REITs.[10] Many of these funds issue several share classes, some aimed at retail investors and others aimed at institutional investors. There are a total of 121 share classes of open-end funds with a minimum investment below $5,000. Three of the largest open-end real estate funds available to retail investors are: the Vanguard REIT Index (VGSIX), Nuveen Real Estate Securities (FREAX), and Fidelity Real Estate Investment Portfolio (FRESX).[11] The VGSIX fund, with over $12.3 billion in total assets, invests at least 98% of its assets in traded REITs and attempts to track the performance of the MSCI US REIT Index.[12] The VGSIX fund requires a minimum investment of $3,000; some other funds require lower minimum investments. A complete list of all open-end real estate fund share classes as well as some of their basic characteristics is available in Panel A of Appendix I.

The fee structure in open-end funds varies by share class. Some share classes have a front-end load on purchases. Other share classes have no front-end load fees but have a back-end load (or contingent deferred sales) charge on redemptions occurring less than a pre-specified time period from the original purchase date. No-load funds cover their sales and distributions costs directly from their operating expenses. Open-end funds have annual operating expenses typically of 1 to 2% of the value of their investment.

Open-end funds from established mutual fund companies provide retail investors with professional management with established track records, access to a wide variety of real estate markets, transparent pricing, large portfolios, and ready liquidity. As we will see below there is a great deal of variation across traded, non-traded and private REITs. Some of these REIT offerings are extremely high cost, extremely poor investments sold to investors by compromised advisors. Mutual fund portfolio managers have incentives to select the best REITs and so provide a valuable service to investors. These mutual funds

[9] A handful of real estate open-end funds invest in foreign real estate investment companies that do not qualify for the REITs denomination.
[10] Information on funds focused on real estate was obtained from Bloomberg.
[11] All of the data on real estate investment companies and traded REITs is from Bloomberg, retrieved on June 27, 2012. The size of the funds is measured in terms of total assets in the portfolio.
[12] The MSCI US REIT Index is a price-only index formerly known as the Morgan Stanley REIT Index. The MSCI US REIT Index represents about 85% of the US traded REITS.

are thus ideal for most retail investors who want additional real estate exposure beyond their homes and the indirect exposure they already have in their investment portfolios.

C. Closed-End Funds Add Additional Leverage.

Like open-end mutual funds, closed-end mutual funds sell shares of professionally-managed portfolios of securities. Unlike open-end funds, closed-end funds issue a fixed number of shares at IPO and their shares are usually nonredeemable until the fund liquidates. Investors buy and sell shares of closed-end funds on an exchange throughout the day at market-determined prices which are typically different from the funds' net asset values.

Because closed-end funds do not need to sell securities to meet redemptions, they have higher permissible leverage and may invest a larger fraction of their portfolio in illiquid securities than other investment companies.[13] Higher leverage enables closed-end funds to enlarge their portfolios for a given value of shares issued. Closed-end-funds may use preferred stock or debt to leverage their portfolio up to leverage limits established in the Investment Company Act of 1940.

Like open end real estate mutual funds, closed-end real estate funds typically own shares of traded REITs. The three largest real estate closed-end funds are: Cohen & Steers Quality Income Realty (RQI), CBRE Clarion Global Real Estate Income (IGR), and Nuveen Real Estate Income Fund (JRS). These funds have no minimum investment and no front or back-end loads. Closed-end funds' annual expense ratios are typically 1-2% of the value of the investment. For more information on real estate closed-end funds, see Panel B of Appendix I.

D. Unit Investment Trusts Hold Static Real Estate Portfolios.

Unit investment trusts are investment companies that invest in passively held portfolios. Unit investment trusts typically hold the same portfolio of securities from inception to maturity. Similar to closed-end funds, unit investment trusts sell a fixed number of shares at their IPO. After the IPO, shares can be purchased or redeemed at their net asset value, like the shares of open-end funds.

First Trust issues all eleven Unit Investment Trusts investing at least 90% of their portfolio in traded REITs including First Trust 1561 REIT Growth (FRGINX), First Trust 1871 REIT Growth (FGROMX), and First Trust 2060 REIT Growth (FRPLJX).

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[13] For the SEC's definition of illiquid securities, see <http://www.sec.gov/answers/mfclose.htm> [accessed 15 March 2012].

E. Real Estate ETFs are an Expanding Market.

Exchange-Traded Funds (ETFs) are often structured as open-end funds, although some may be structured as unit investment trusts. There are nineteen ETFs with over 90% of their portfolio invested in traded REITs. The oldest of the REIT ETFs has been operating since 2000 but many of them commenced operations after 2007. The largest REIT ETF is Vanguard REIT ETF (VNQ) which, with over $12.0 billion in assets, tracks the MSCI REIT Index. Other REIT ETFs include iShares' Dow Jones US Real Estate ETF (IYR) and iShares Cohen & Steers Realty ETF (ICF). REIT ETFs have no front load or back load fees and have an annual expense ratio that ranges from 0.12% to 0.80% of total investment.

F. Real Estate Investment Trusts Typically Concentrate Their Holdings.

Rather than investing in real estate mutual funds or ETFs, retail investors can purchase shares issued by real estate investment trusts (REITs). REITs typically hold several properties in a portfolio and are subdivided by their particular holdings (office, retail, storage, mortgage, etc.). REITs therefore tend to be less diversified than real estate mutual funds and ETFs, but can be used for targeted exposure to particular geographic regions or asset classes within the broader real estate market.

REITs must comply with a variety of regulatory constraints.[14] REITs must have at least 100 shareholders with no five owning more than 50% of the REITs shares. Most of a REITs' assets must be interests in real estate or in other REITs. REITs must earn almost all of their revenues from real estate investments and pay out almost all of those revenues to investors. Meeting these provisions, a REIT is allowed to deduct all of its dividend payments to shareholders from its taxable income thereby avoiding being taxed at the corporate level.

The way a REIT is sold can have a large effect on its underlying risk factors. According to the IRS, approximately 1,100 REITs have filed tax returns in the US, as of January 1, 2011, 153 of these were publicly traded on one of the major stock exchanges.[15] Examples of traded REITs include Simon Property Group (SPG), American Tower Corporation (AMT), and Public Storage (PSA). About 60 more are non-traded REITs, also known as 'non-listed' or 'unlisted' REITs, which are registered with the SEC but

[14] NAREIT: National Association of Real Estate Investment Trusts, 'Forming and Operating a Real Estate Investment Trust', in *REIT.com* <http://www.reit.com/AboutREITs/FormingaREIT.aspx> [accessed 22 September 2011]
[15] NAREIT: National Association of Real Estate Investment Trusts, 'Frequently Asked Questions About REITs', in *REIT.com* <http://www.reit.com/portals/0/PDF/2011FAQ.pdf> [accessed 22 September 2011]

whose shares are not listed on an exchange. Examples of non-traded REITs are Apple REIT Six-Ten, Behringer Harvard Opportunity REITs I-II, Inland American REIT and Hines Global REIT. The remaining 800-850 are private placements, meaning they are not registered with the SEC and very little information is available about their structure and holdings. Examples of private REITs are Wells Limited Partnerships, Rancon Realty Fund, and Lightstone Value Plus.

While traded REITs are highly liquid, and many receive substantial media and analyst attention, non-traded and private REITs, are illiquid and their holdings and valuations are non-transparent.

G. Tenants in Common Are Even More Illiquid, Less Transparent, and Less Diversified.

Investors can also purchase real estate exposure by purchasing interests in an individual property through a Tenants in Common ('TIC'). In a TIC, the property is professionally managed and each owner receives a proportion of the net income based on his or her fractional ownership. Evolving tax regulation has boosted the market for TICs. Section 1031 of the Internal Revenue Code of 1986 allows for an exchange of property in which an investor can dispose of real estate property, purchase interests in another property, and, under some conditions, defer the payment of capital gains tax on the property he sold. TIC sponsors market their offerings as an effective way of exchanging real estate without incurring capital gains tax.[16] TICs are undiversified and highly illiquid, as TIC interests are not traded in any public market.[17]

IV. Non-Traded REITs Suffer from Conflicts of Interest, Illiquidity, and Unreliable Reported Values.

Despite the recent widespread collapse in commercial and residential real estate asset values, non-traded REITs continue to attract new investment. New issuances of non-traded REITs in 2011 totaled $8.6 billion; the total assets of non-traded REITs are now over $82 billion.[18] The lure of high, regular distributions styled as dividends and the apparent low price volatility made non-traded REITs seem like safe and reliable

[16] See for example, Pacific Investment Properties' marketing material <http://www.pacificinvestmentproperties.com/1031-exchanges.html> [accessed 14 January 2012].

[17] FINRA released a Notice to Members regarding TIC investments in March 2005, highlighting potential infractions related to suitability, due diligence, and other sales related regulations. See FINRA NTM 05-18, March 2005.

[18] Partnership Profiles, Inc, 'Nonlisted REIT Fundraising Soars in 2011', *Direct Investments Spectrum*, January/February 2012 and 'NonListed REITs Ranked by Total Assets', *Direct Investments Spectrum*, March/April 2012. Data as of December 31, 2011.

investments to many investors. Indeed much of the growth in non-traded REIT investment has come from retirement and other conservative retail investors.[19]

Recently, non-traded REITs have come under increased scrutiny from FINRA and the SEC for allegedly misleading investors about the value of their investments.[20] Some non-traded REITs have paid a substantial portion of their dividends out of the proceeds from issuing debt rather than from earnings on their real estate holdings, and have not updated their share valuations to reflect decreasing net asset values of their portfolios, giving an illusion of price stability. Some non-traded REITs have even suspended redemptions pending regulatory action. While non-traded REITs claim to offer retail investors access to professional managers and real estate assets typically only available to institutional investors or high net worth individuals, they may in fact use their relative lack of transparency to deceive these relatively unsophisticated customers.

A. Non-Traded REITs are Rife with Conflicts of Interest and Attendant High Fees.

Non-traded REITs are typically ‘serviced by’ or ‘attended to by’ an owner/sponsor, an advisor, a property manager, and a dealer manager, none of whom may be the same entity (but they may be affiliated – see “Fees” below). A REIT’s sponsor is the person or company that organizes and controls the underlying properties in the REIT’s portfolio. The property manager is responsible for the leasing and maintenance of the property. Advisors make investment decisions such as purchasing, developing, and selling properties for the portfolio in addition to managing day-to-day operations. The dealer manager is responsible for marketing and selling the shares of the REIT to investors. In many cases, any or all of these roles may be played by affiliated entities.

The commonality of key individuals and entities in multiple aspects of a REIT’s business can lead to substantial conflicts of interest, especially for the less transparent non-traded and private REITs. For example, the sponsor, in his dual role of real estate owner and major shareholder of the REIT, has a conflict of interest that puts other investors in the REIT at a disadvantage. If the sponsor wishes to sell a particular property, the REIT could be offered the right to purchase it before it goes on the open market. As a major shareholder, the sponsor could then influence the decision to purchase

[19] Anton Troianovski and Craig Karmin, 'Nontraded REITs Are Put on Notice by SEC', *Wall Street Journal*, 29 June 2011.

[20] Terry Pristin, 'A Closer, and Skeptical, Look at Nontraded REITs', *The New York Times*, 19 July 2011., Anton Troianovski and Craig Karmin, 'Nontraded REITs Are Put on Notice by SEC', *Wall Street Journal*, 29 June 2011. FINRA Investor Alert <http://www.finra.org/Investors/ProtectYourself /InvestorAlerts/REITS/P124232> [accessed 27 July 2012].

the asset at an above-market price. This was especially a concern in early REITs, but has since been mitigated in most traded REITs by specific prohibitions on such insider transactions.[21] Insider transactions have remained a concern for non-traded REITs, especially for entities which manage several different REITs (for example, the Apple REITs). There are substantial opportunities for a REIT sponsor, perhaps through its affiliates, to (1) use the credit line of one REIT to finance the operations or dividends payments of another, (2) artificially increase asset turnover to maximize compensation, (3) allocate a substantial portion of over- or under-performing assets to a single REIT at the expense / favor of others, or (4) use his or her managerial knowledge of, or influence in, a REIT to benefit other, unrelated investments.

The dealer-manager is often paid excessive commissions for selling shares, as high as 10% of the share price. These rates are substantially higher than on mutual funds and ETFs, which have commission levels of typically 2-3%. These extraordinarily high fees incentivize dealer-managers to sell as many shares as possible, regardless of the suitability of the investment for an individual's financial objectives. This could lead to the targeting of unsophisticated investors in particular.

The advisor, sponsor, and dealer manager are often controlled by the same management team. Therefore, while NASAA has published guidelines restricting the ability of the sponsor and advisor to sell properties to, offer financing to, or jointly invest with the REIT, these guidelines are effectively sidestepped by the creation of several special purpose entities, all controlled by the same management team, which conduct these transactions as technically 'external' entities. For example, Behringer Harvard Opportunity REIT I lists the following associated entities in various roles:

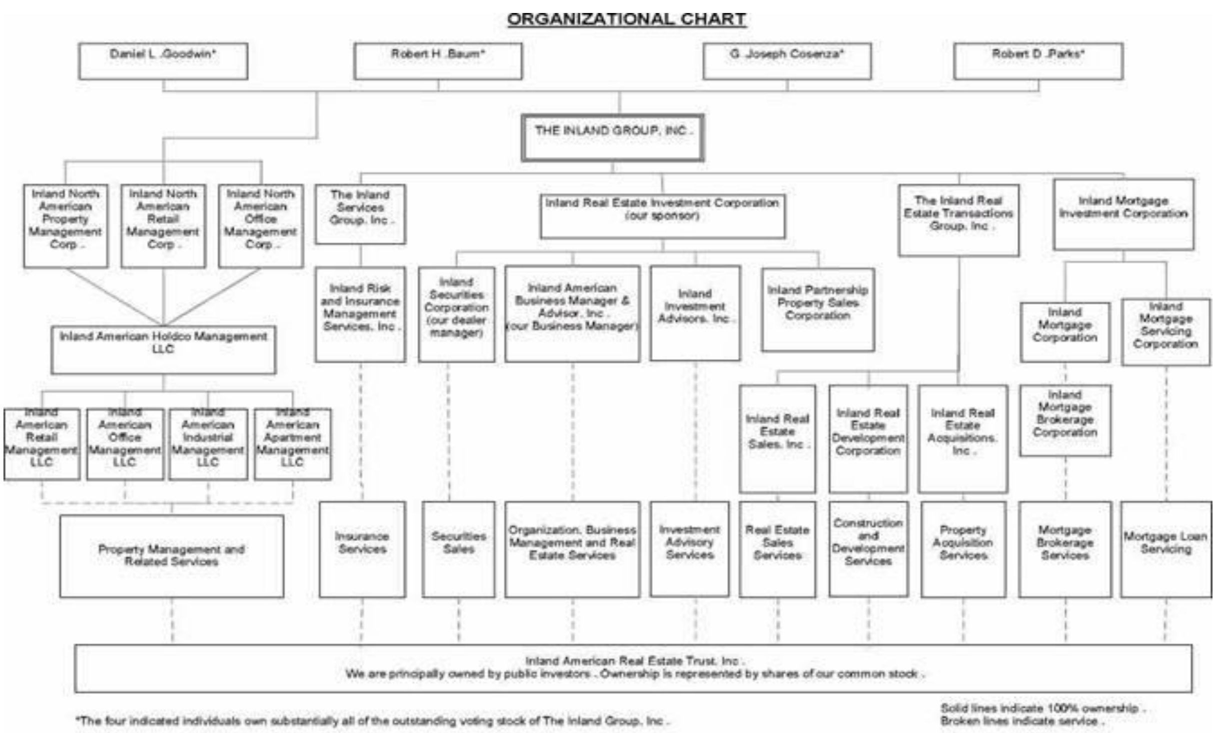
Advisor: Behringer Harvard Opportunity Advisors I
Sponsor: Behringer Harvard Holdings, LLC (100% owner of affiliate)
Dealer manager: Behringer Securities LP
Limited partner: BHO Partners
Operating partnership: Behringer Harvard Opportunity OP I, LP
Property manager: HPT Management Services
Affiliate: Behringer Harvard Partners (99.9% owner of advisor, dealer manager, and property manager)

Behringer also notes that: "We may acquire properties…with affiliated entities, including Behringer Development, a wholly owned subsidiary of Behringer Harvard Partners, which is a wholly owned subsidiary of Behringer Harvard Holdings, and BHD,

[21] Ralph L. Block, *Investing in REITs: Real Estate Investment Trusts*, Third Edition edn ([n.p]: Bloomberg, 2006).

LLC, which is a wholly owned subsidiary of Behringer Harvard Holdings."[22] Nor is this maze of partnerships and sub-companies unique to Behringer Harvard. Inland American REIT provided the following diagram to illustrate the ownership structure of its organization.[23] These complicated structures enable a small group of senior managers (see footnote on Figure 2) to conduct transactions between their various entities and affiliations and collect high fees.

Figure 2: Inland American REIT



Advisors and dealer managers can be paid up to 15% of the proceeds raised in an initial share offering as "organization and offering expenses."[24] Based on the SEC filings of non-traded REITs, property managers receive 2-3% of the gross revenue from the properties they manage. Affiliates (including the advisor or sponsor) may receive a commission up to 3% of the price for any property sold to the REIT. External advisors receive acquisition and asset management fees as large as 6% of the offering price and

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[22] Behringer Harvard Opportunity Trust I, Inc, 'Prospectus dated June 1, 2006', in *SEC.gov* <http://sec.gov/Archives/edgar/data/1308711/000110465906038889/a06-12877_1424b3.htm> [accessed 22 September 2011]

[23] Inland American Real Estate Trust, 'Prospectus dated August 1, 2007', in *SEC.gov* <http://sec.gov/Archives/edgar/data/1307748/000110465907058012/a07-20593_1424b3.htm> [accessed 15 February 2012]

[24] NASAA: North American Securities Administrators Association, 'Statement of Policy Regarding Real Estate Investment Trusts', in *NASAA.org* <http://www.nasaa.org/content/Files/REITS.pdf> [accessed 22 September 2011]

expense payments of up to 2% of the invested assets. Most REIT advisors are wholly owned subsidiaries or affiliates of the sponsor yet are classified as external advisors, which allows them to collect fees from investors. Dealers who sell the shares are also very frequently controlled by the sponsor or advisor. Thus, the fees from offerings and day-to-day operations of the REIT can all go to the same management group.

In summation, $1.50 to $2.00 of the $10 investors pay for a share of a non-traded REIT is used to pay fees to the sponsor and affiliated companies and only $8.00 to $8.50 is invested into the operations and holdings of the REIT itself. With 15% of the share proceeds, and other transaction fees and commissions, the sponsor has a significant incentive to sell as many shares as possible rather than returning value to shareholders. Likewise, when additional fees can be generated by buying, selling, developing, or managing properties, management has an interest in maximizing the number and size of transactions without regard to the value created for investors.

Table 2: Example of Non-Traded REITs fees[25]

Fee	Recipient	Units	Level
Selling commission	Dealer manager	% of share price	7%
Dealer manager fee	Dealer manager	% of share price	2-3%
Marketing allowance	Dealer manager	% of share price	1-3%
Organization and offering expenses	Dealer manager or advisor	% of gross offering proceeds	Max 15%
Acquisition fees	Advisor	% of purchase price of property	Max 6%
Acquisition expense reimbursement	Advisor	% of purchase price of property	4%
Asset management fee	Advisor	% of properties' gross revenues	4%
Property management fee	Property management company	% of properties' gross revenues	4%
Oversight fee	Property management company	% of properties' gross revenues	1%
Construction fee	Development company	% of cost of construction	4-6%
Operating expenses	Advisor	% of average invested assets	2%
Financing coordination fee	Advisor	% of coordinated financing	1%
Real estate commissions	Advisor	% of sales price of property	2%

[25] Source: SEC filings of 57 non-traded REITs as of Q3 2011.

B. Non Traded REITs Are Illiquid and Have Unreliable Reported Values.

Non-traded REITs are illiquid investments. As no public secondary market exists for shares of non-traded REITs, investors are effectively unable to sell their shares even if the value of the REIT or its underlying assets significantly decrease. In order to mask this illiquidity and justify their reported valuations, many non-traded REITs offer grossly imbalanced repurchase programs through which investors can sell their shares to other investors or back to brokers at a significantly lower price. These repurchase programs come with restrictions. Investors can participate in the repurchase program only after an initial holding period, typically a year, and if there are a large number of shareholders wanting to sell, the non-traded REIT's management reserves the right to limit the number of shares that can be sold or to discontinue the program altogether.

For example, shares of Behringer Harvard Opportunity REIT I were initially sold in 2005 for $10 per share and reported to be worth $10 per share for years thereafter. On May 2010, management's reported per share valuation was $4.25. This updated valuation was only reported after a regulatory notice from FINRA requiring all non-traded REITs report an estimated share value within 18 months of their final offering.[26] Anticipating the investor outrage that soon followed, the sponsor limited redemptions to the lesser of 90% of the average price paid per share or 90% of the $4.25 valuation reported on that day.[27] On January 10, 2011, it suspended its redemption program altogether.[28] Likewise, in December 2009 Hines REIT, one of the largest non-traded REITs with over $3.3 billion in total assets, suspended its redemption policy. In late June 2010, the company began noting in its quarterly SEC filings that market conditions would likely lead to an eventual lower share price, but chose to maintain its price at $10.08 per share until *May 26, 2011* – almost a year later – when management reduced the share value to $7.78. These examples highlight the potentially misleading nature of non-traded REIT share valuations, as well as management's discretion in limiting or even eliminating the liquidity of its shares.

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[26] FINRA: Financial Industry Regulatory Authority, 'FINRA Rule 2340', in *FINRA Manual, NASD Rules* <http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=3647> [accessed 22 September 2011]

[27] Behringer Harvard REIT I, Inc, 'Letter to Shareholders', in *SEC.gov* <http://www.sec.gov/Archives/edgar/data/1176373/000110465910030422/a10-10797_1ex99d1.htm> [accessed 22 September 2011]

[28] Behringer Harvard Opportunity REIT I, Inc, 'SEC Form 8-K', in *SEC.gov* <http://sec.gov/Archives/edgar/data/1308711/000110465911001657/a11-4076_18k.htm> [accessed 22 September 2011]

While no public market exists for non-traded REIT shares, some private markets have created listings for these funds, facilitating exchanges.[29] However, any individual who purchases shares in this way is ineligible for whatever share redemption program is offered by the REIT, meaning that those shares become *completely* illiquid at the time of purchase, and that the secondary purchaser can only collect dividend payments until redemption. For this reason, shares of non-traded REITs tend to trade at a discount to reported share price, in addition to any loss of value being priced in by the market.[30] MacKenzie Patterson Fuller, a real estate investment management firm, has filed tender offers for several non-traded REITs at substantial discounts to initial offering prices.[31] *Direct Investments Spectrum* reported non-traded REIT shares selling in secondary markets as low as $2.67 in November 2011, and only one (Corporate Property Associates 15) above $9.00.[32] It is clear that wherever active markets have priced these shares they have generally revealed the declining asset values of these non-traded REIT holdings.

FINRA Rule 2340 governs how non-traded REITs are allowed to report their estimated per share values.[33] It requires that the per share value be calculated using data no more than 18 months old, and that

> 'a [FINRA] member must refrain from including a per share estimated value for a DPP or REIT security on an account statement if the member can demonstrate the value was inaccurate as of the date of the valuation or is no longer accurate as a result of a material change in the operations or assets of the program or trust.'

However, Rule 2340 did not explicitly require a non-traded REIT to report a per share value, even one as stale as 18 months.

FINRA published a regulatory Notice in September 2009 clarifying that Rule 2340 requires non-traded REITs to use current estimated share values (as opposed to 'par values', or initial offering prices) in their customers' account statements 18 months after the initial share offering.[34] As a result of this change, many investors have been shocked

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[29] Indeed, some non-traded REIT shares have even been listed on Craigslist.
[30] Examples include REIT Secondary Exchange and the American Partnership Board.
[31] MacKenzie Patterson Fuller, LP, 'List of Current Tender Offers', in *MPFI.com* <http://www.mpfi.com/Tenders/tender_offers.htm> [accessed 22 September 2011] Copies of the tender offers are also available under each non-traded REIT's SEC filings page.
[32] Partnership Profiles, Inc, 'Nonlisted REITs Boost Secondary Market', *Direct Investment Spectrum*, November/December 2011.
[33] FINRA: Financial Industry Regulatory Authority, 'FINRA Rule 2340', in *FINRA Manual, NASD Rules* <http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=3647> [accessed 22 September 2011]
[34] FINRA: Financial Industry Regulatory Authority, 'Customer Account Statements and Due Diligence Requirements for Unlisted Real Estate Investment Trusts (REITs) and Direct Participation Programs

to learn for the first time the actual value of their shares. For example, the Cole Credit Property Trust revised its estimated share value from its initial price of $10 to $7.65 after the FINRA Notice, but this value was established by the REIT's board of directors based on information from the advisor, not by any third party.[35] FINRA is reportedly drafting rule changes that would require non-traded REIT broker dealers to report estimated share values 'considerably' faster than the 18 months currently required which would significantly affect non-traded REIT share prices.[36] The MCSI US REIT index, a price-only index of traded REITs, dropped over 76% from 2007-2009, and remains well below the values seen in the early and mid 2000s when most non-traded REITs were first issued. In limited secondary market trading, non-traded REITs typically sell for between $5-8 per share.[37]

The increasing media scrutiny of non-traded REITs has led to the development of several non-traded REITs with increased price transparency. The American Realty Capital Daily Net Asset Value Trust and the Clarion Partners Property Trust both intend to publish daily net asset value calculations once they complete their initial funding.[38] While the accuracy of these estimates is subject to the practices of the individual REIT and depend on the frequency and objectivity of the underlying property appraisals, demand for these new non-traded REITs reflect the degree to which investors' view of the sector as a whole has been affected by lack of transparency in asset values. Under FINRA and SEC guidelines daily pricing could lead to broader marketing of non-traded REITs to unsophisticated investors by dealers seeking high commissions.

C. The Financial Reality of Non-Traded REITs Uncovered

1. The Apple REITs

Many of the potential deficiencies and conflicts of interest in non-traded REITs we have discussed above were brought to the public's attention as a result of a FINRA complaint against David Lerner Associates, Inc. (DLA), the sole dealer-manager for the

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(DPPs)', in *FINRA Manual, Notices* <http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=10450&element_id=7408&highlight=reit#r10450> [accessed 22 September 2011]

[35] See subsequent revaluation to $7.95: Cole Credit Property Trust, 'Form 8-K dated January 11, 2012', in *SEC.gov* <http://sec.gov/Archives/edgar/data/1289272/000128927212000002/ccpt_valuation8-k.htm> [accessed 15 February 2012]

[36] Bruce Kelly, 'Faster pricing of nontraded REITs sought', *InvestmentNews*, 25 September 2011.

[37] Partnership Profiles, Inc, 'Nonlisted REITs Boost Secondary Market', *Direct Investment Spectrum*, November/December 2011.

[38] Bruce Kelly, 'A new breed of nontraded REITs', *InvestmentNews*, 28 August 2011. and American Realty Capital Daily Net Asset Value Trust, Inc, 'Prospectus dated August 15, 2011', in *SEC.gov* <http://sec.gov/Archives/edgar/data/1501745/000114420411048006/v232440_424b3.htm> [accessed 22 September 2011]. Both of these non-traded REITs had commenced their Initial Public Offering by 27 July 2012, according to Bloomberg.

ten Apple REITs issued since 1992.[39] The complaint, filed on May 27, 2011, alleges that as the dealer manager DLA "should have been aware of valuation irregularities and other improprieties" in the Apple REITs and that broker dealers have a due diligence responsibility to obtain accurate valuations of non-traded REITs, despite unchanging share prices. The complaint details the market fluctuations, deteriorating financial performance, and increased leverage of the Apple REITs, and argues that by maintaining only average distribution information on its website DLA was misleading investors about the quality of their investments. DLA had also been found by the SEC in May 19, 2004 to have, on three occasions, sold clients "illiquid DLA-underwritten REIT securities that were unsuitable for the customers, given the customers' investment objectives, financial situation, and need for liquidity."[40]

The DLA complaint shines a spotlight on many standard practices in the non-traded REIT market. The market conditions outlined in the complaint that have led to the severe deterioration in the value of the Apple REITs are also applicable to many other non-traded REITs; moreover, essentially all non-traded REITs fail to update their share prices until the 18 month FINRA-mandated revaluation.[41] The fees and incentives to DLA as dealer manager are also standard for the industry (which is to say, very high), so any incentive DLA may have had to aggressively market non-traded REITs over other conservative investments is shared by virtually all dealer managers. And just as DLA was "targeting unsophisticated and elderly customers to buy the illiquid securit[ies]", non-traded REITs are routinely marketed by others as dependable long-term investments.

2. Leverage – Not Earnings – Funds Dividends

Apple REITs sold by DLA were highly leveraged, that is, financed from debt rather than retained earnings. High levels of borrowing are common in non-traded REITs. For example, the Corporate Property Associates 15 REIT paid over $94 million in dividends in 2011 on cash flow from operations of $164 million.[42] However, due to $1.3 billion in long term debt (and a 132% debt-to-equity ratio), their cash flow from financing was -$283 million, negating all of their operating income. The bulk of their negative cash flow from financing went to payments on mortgage principal. This pattern of financing costs equaling or exceeding operating income has persisted for Corporate

[39] FINRA Department of Enforcement, 'Complaint v David Lerner Associates, Inc.', in *disciplinaryactions.finra.org* <http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=17059>
[40] FINRA Department of Enforcement, 'Order Accepting Offer of Settlement', in *disciplinaryactions.finra.org* <http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=14952>
[41] Two non-traded REITs offering daily estimated prices have been registered with the SEC, and their listing is pending as of 27 July 2012.
[42] Corporate Property Associates 15 Incorporated, Annual Report for the fiscal year ended December 31, 2011.

Property Associates 15 since early 2010. REITs that have large debt burdens may find it difficult to maintain their high dividend payments in the future, and investors interested in non-traded REITs should be aware that the debt loads incurred by REITs to support their dividend and commission levels is a significant drag on future earnings.

One measure of the degree to which dividends are paid from operating cash flows is the dividend coverage ratio. For REITs, dividend coverage is measured by dividing funds from operations (FFO) by total dividends paid. This ratio reflects the percent of dividend payments that came from sources related to the REIT's real estate earnings, as opposed to debt. Therefore a company that pays dividends entirely out of earnings has a dividend coverage ratio of at least 100%, and the higher the percentage the stronger the financial position of the company. A company that has a dividend coverage ratio of less than 100% is paying higher dividends than it is generating in earnings, and must support those dividends through debt, liquidation of assets, or additional investor contributions. Hines REIT, for example, paid nearly $122 million in dividends in 2010 on $77 million in funds from operations, for a dividend coverage ratio of only 63%. In the same year, Cornerstone Healthcare Plus REIT paid $5.6 million in cash dividends on $275,000 in funds from operations. Many dividend 'payments' for non-traded REITs take the form of dividend reinvestment programs ('DRIPs'), but even the cash dividends paid by many REITs outstrip their operating income, sometimes by very large amounts.

Often, non-traded REIT earnings and/or FFO are negative, even for long periods of time. For example, KBS REIT, Inc. has reported negative earnings per share since the beginning of 2009 (see Figure 3). This has not prevented them, however, from paying $48.7 million in dividends ($25.5 million in cash dividends) in just the first two quarters of 2011. Likewise, both Inland American and Hines REITs—some of the largest non-traded REITs by volume, continue to report earnings and FFOs that do not cover their substantial dividend payments (Figure 4 and Figure 5). Of the 42 non-traded REITs tracked by the Direct Investment Spectrum with data on both dividends per share and FFOs, only fifteen reported complete dividend coverage with FFO in the second quarter of 2012.[43]

[43] 'ARC Leads Nonlisted REIT Fundraising,' *Direct Investment Spectrum*, July/August 2012, p.2

Figure 3: KBS REIT Dividend Coverage

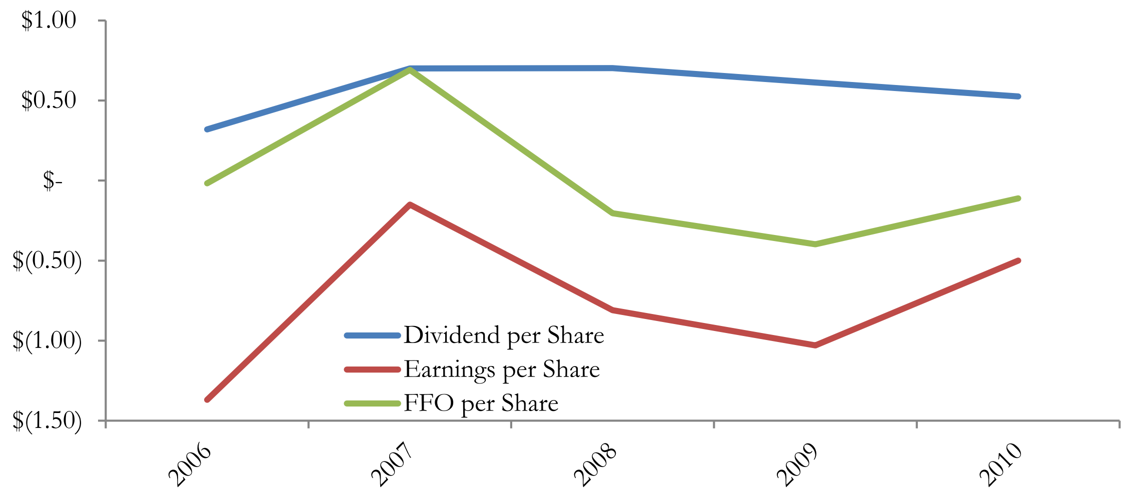


Figure 4: Inland American Dividend Coverage

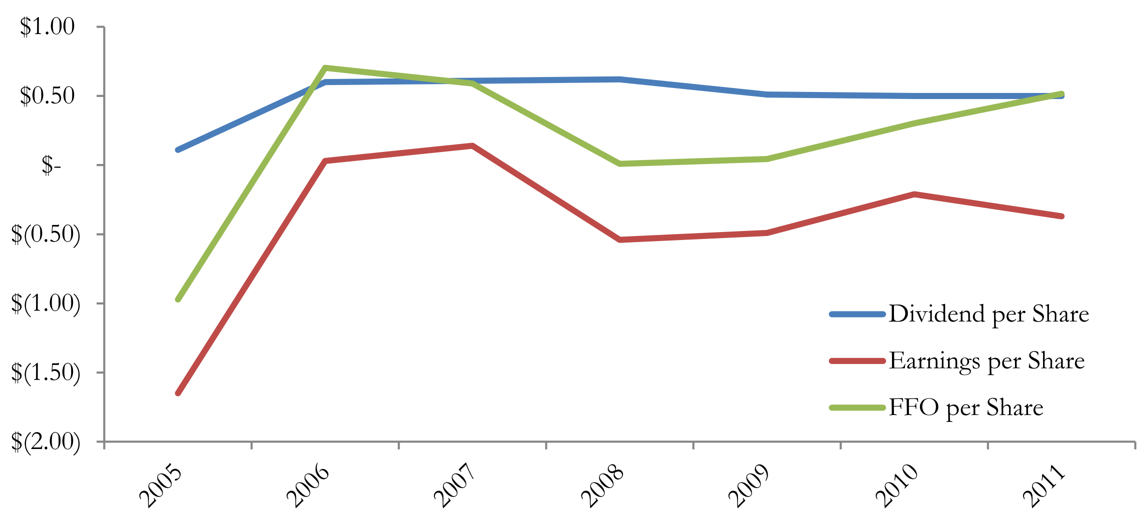
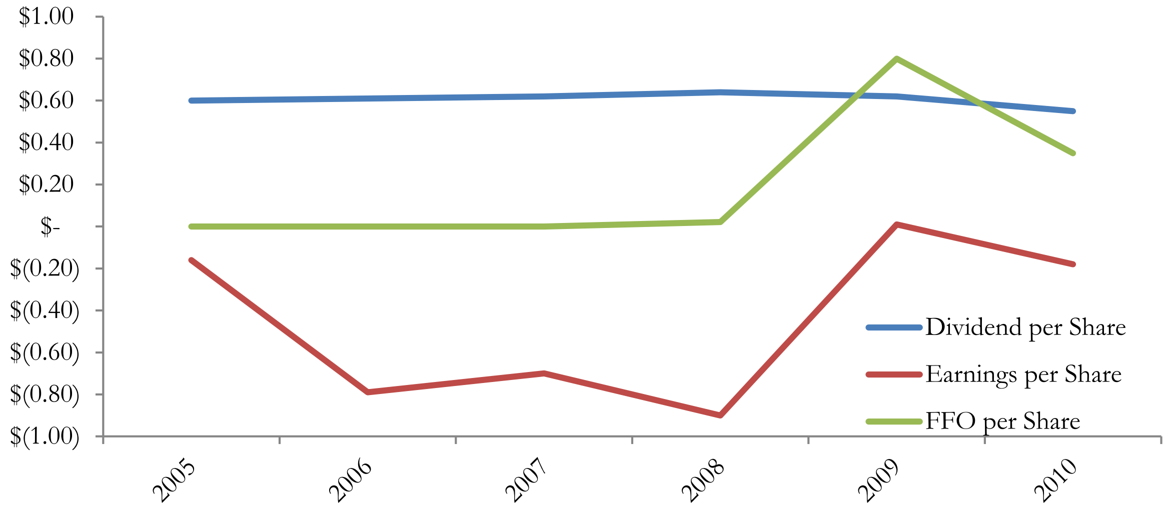


Figure 5: Hines REIT Dividend Coverage



3. Non-traded REITs Tend to be Financially Weak

Return on equity (ROE) is a ratio of net income to shareholder's equity, and represents the income generated from a particular amount of equity investment.

$$ROE = \frac{Net\ Income}{Total\ Equity}$$

DuPont analysis is a way to evaluate the overall condition and performance of a company by breaking down ROE into 3 components.[44]

$$ROE = \frac{\boldsymbol{Net\ Income}}{Revenue} * \frac{Revenue}{Total\ Assets} * \frac{Total\ Assets}{\boldsymbol{Total\ Equity}}$$

$$ROE = Profit\ to\ Sales\ ratio * Sales\ to\ Assets\ ratio * Leverage\ ratio$$

Or:

$$ROE = Net\ Profit\ Margin * Total\ Asset\ Turnover * Financial\ Leverage$$

Net profit margin is net income as a percentage of total revenue, which reflects the profitability of the firm from sales. For REITs net income is typically replaced by FFO, and we adopt this convention in our subsequent analysis. Total asset turnover

[44] Timothy G. Haight and Daniel D. Singer, *The Real Estate Investment Handbook* (Hoboken: John Wiley & Sons, 2005).

reflects a REIT's efficiency – how much revenue it generates from each $1 of assets. The product of these two ratios is the return on assets, or how much income is generated by each $1 of investment. The last component in ROE is the leverage ratio. Since total assets are the sum of a company's total debt and equity, if, for example, this ratio is 1.5, it follows that 50% of shareholders' equity reflects leveraged borrowing.

DuPont analysis breaks ROE down into measures of profitability, efficiency, and leverage. Therefore, if ROE shows poor performance – which is common for non-traded REITs – DuPont analysis can help identify the source of that company's weakness.

Table 3 shows an annual DuPont analysis for KBS REIT since its inception in 2006 through 2012. The net profit margin for KBS was positive only one year, leading to consistently negative return on equity, and its financial leverage was very high, suggesting that a significant amount of dividend payments were financed with debt. Likewise both Inland American and Hines REITs show low return on equity (driven by low or negative FFO) as well as a high degree of leverage.

Table 3: DuPont Analysis of KBS REIT

	Net Profit Margin	Total Asset Turnover	Financial Leverage	ROE
2006	-0.6%	1.9%	302.3%	-0.04%
2007	35.2%	5.1%	257.1%	4.60%
2008	-11.1%	9.4%	233.3%	-2.42%
2009	-25.6%	10.5%	267.3%	-7.17%
2010	-8.3%	10.1%	282.3%	-2.36%

Table 4: DuPont Analysis of Inland American

	Net Profit Margin	Total Asset Turnover	Financial Leverage	ROE
2005	-12.9%	0.8%	1017.6%	-1.01%
2006	39.0%	4.1%	204.9%	3.24%
2007	52.1%	5.7%	178.0%	5.29%
2008	13.9%	9.0%	182.2%	2.29%
2009	13.5%	9.3%	201.8%	2.54%
2010	27.1%	10.4%	217.1%	6.13%
2011	33.5%	12.1%	234.1%	9.51%

Table 5: DuPont Analysis of Hines REIT

	Net Profit Margin	Total Asset Turnover	Financial Leverage	ROE
2005	-28.1%	2.1%	158.1%	-0.93%
2006	-60.2%	5.3%	188.9%	-5.99%
2007	-48.8%	6.6%	219.2%	-7.11%
2008	-49.6%	10.2%	248.7%	-12.54%
2009	0.7%	10.6%	237.0%	0.19%

D. Implications for the Private Placement REIT Market

Non-traded REITs have been sold in small denominations to unsophisticated retail investors who have only become aware of the significantly misleading features of non-traded REITs through media coverage of high-profile regulatory action on the part of FINRA and the SEC. The private placement REIT market has for many years been much larger than the registered (traded and non-traded) REITs. IRS filings show that there are somewhere between 900 and 1,200 private placement REITs in the US.[45] Investors in private placement REITs have almost no independent information on the holdings, incentives, and interdependencies embedded in their structure. While private placement REITs are *even more* opaque and illiquid than non-traded REITs, the level of wealth and sophistication of the investors eligible to purchase these private placements may have limited the abuses in private placement REITS.

V. Tenants-in-Common: Less Liquid, Less Diversified and Less Transparent Than Non-Traded REITs

The term "Tenants-in-Common" (TICs) refers to a fractional interest in an undivided real estate property. Although the legal term "Tenants-in-Common" has a broad interpretation that includes, for example, a set of relatives purchasing property together and sharing ownership rights to it, this section of the paper refers to the professional securitization of interests in real estate property. A TIC sponsor purchases the same types of commercial real estate property that REITs purchase. A key difference between a TIC and a REIT is that unlike REIT investors, who are shareholders of a company that owns real estate, TIC investors directly own a fraction of the property and assume a proportionate amount of the non-recourse loan used to purchase the property. Another important difference between TICs and other types of securitized real estate investments is that the exchange of real estate property for TIC interests typically qualifies for the deferral of capital gains tax on the property the investor initially owned.

[45] Gail Liberman, 'Private REIT Explosion', *Financial Advisor Magazine*, June 2010., NAREIT: National Association of Real Estate Investment Trusts, 'Frequently Asked Questions About REITs', in *REIT.com* <http://www.reit.com/portals/0/PDF/2011FAQ.pdf> [accessed 22 September 2011]

Nevertheless, TICs suffer from many of the same problems that infect non-traded REITs: lack of liquidity, little price transparency, excessive fees, and distributions that may be paid from offering proceeds or debt. Hence, as discussed in more detail in the next section, the tax deferral benefits of TICs are typically more than offset by these other features.

TICs are sold through private placement offerings under the SEC’s Regulation D. As such, TIC sponsors do not need to comply with the typical registration requirements of the Securities Act of 1933 that apply to most issuers of securities. The number of co-owners in a single TIC is limited to 35 persons as a requirement to qualify for tax deferral exchanges.[46] Since the number of TIC owners is limited, there are minimum investment requirements that are often on the order of tens of thousands of dollars but may be hundreds of thousands of dollars.[47] In addition, TIC investments typically require a minimum holding period of five to seven years.

TICs qualify for tax-free exchanges of property under Section 1031 of the Internal Revenue Code of 1986.[48] One requirement of Section 1031 Exchange is that the investor must identify the replacement property and complete the exchange there within a limited time period. Potential replacement properties must be identified within 45 days of the original property’s transfer and the purchase of the replacement property must be completed in less than 180 days. The need for timely purchases of replacement properties has fueled the TIC industry. Until a decade ago existing Internal Revenue Service (IRS) ruling did not specify whether TIC interests would be considered interests in a partnership, which are explicitly excluded from allowable Section 1031 tax-deferred exchanges. The market for TICs received a boost in 2002 with the IRS Revenue Procedure 2002-22 which clarified that TIC interests may be used as replacement property in Section 1031 exchanges.[49]

Section 1031 tax-deferral exchanges have attracted investors to securitized TICs. After the Revenue Procedure, investment in TICs increased more than ten-fold in five

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[46] Internal Revenue Code of 1986, Section 1031, *Ibid*. “Persons” as defined in Section 7701(a) (1).
[47] For example, a minimum purchase of 2.91% interest, approximately $638,700 of equity, was required by Direct Invest- Braintree Park, LLC., according to its Private Placement Memorandum dated 13 August 2007.
[48] Internal Revenue Code of 1986, Section 1031 <http://www.law.cornell.edu/uscode/usc_sec_26_00001031----000-.html> [accessed 10 January 2012]
[49] Internal Revenue Code, Revenue Procedure 2002-22, 26 CFR 601.201 < http://www.irs.gov/pub/irs-irbs/irb02-14.pdf> [accessed 10 January 2012]. Also, for an analysis of the procedure’s effect on TIC investment see Shawn R. Wamstad, “A boost from the IRS,” *Business Law Today*, Vol. 13, No. 4, March/April 2014 <http://apps.americanbar.org/buslaw/blt/2004-03-04/wamstad.shtml> [accessed 10 January 2012].

years, from $356 million in 2002 to $3.7 billion in 2006.[50] In 2008, the boom in the TIC industry came to an abrupt halt as the broader real estate market struggled with the housing and financial crises. Investment in TICs dropped from $5.5 billion in 2007 to $783 million from January to October 2008.[51] According to the marketing material for TICs, the main advantages of TICs continue to be the deferral of capital gains tax.[52] However, a TIC's tax deferral benefit is more than offset by other factors as shown in the following sections.

A. TIC's Tax Deferral is More Than Outweighed by High Costs

Capital gains are typically subject to federal and state taxes. The maximum federal long term capital gains tax rate was at a historical low of 15% from May 6, 2003 to December 31, 2010.[53] It increased to 20% on January 1, 2011 and may increase to 23.8% in January 2013. While some states do not levy a capital gains tax, the average state capital gains tax rate is 5.6%, according to marketing material promoting Section 1031 exchanges.[54]

Although the marketing material for TICs emphasize that TIC investors earn a steady income stream on the untaxed proceeds of their Section 1031 exchanges, much of the tax deferral benefit is lost in upfront fees paid to the entities involved in the offering. The remaining tax deferral benefits, if any, are offset by the TIC's annual fees and additional expenses. The next section provides an example of the large fees involved in TIC investing.

B. Conflicts of Interest and Excessive Fees in TICs Mirror Those in REITs.

Table 6 shows an example of the fees payable by TIC investors and the entities receiving these fees. Direct Invest – Braintree Park, LLC is the Sponsor involved in the offering of almost $22 million in equity in the form of TIC interests on a property located in Braintree, Massachusetts, including about 40 acres of land, a four-building office, an industrial complex, and some undeveloped land.[55] Direct Invest – Braintree Park, LLC is

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[50] Heshelow, Kathy, "Effortless cash flow: The ABC's of TICs (Tenant in Common properties)", iUniverse, Inc, 2006, p. 2.
[51] Hagel, Jack, "Biting the securitized-TICs bullet," The News & Observer, November 13, 2008.
[52] See for example, <http://tic.com/Default.aspx> and <http://www.pacificinvestmentproperties.com/1031-exchanges.html> [accessed 10 January 2012].
[53] Tax Policy Center, Historical Capital Gains and Taxes, <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=161> and Tax Foundation, Federal Capital Gains Tax Rates, <http://www.taxfoundation.org/taxdata/show/2088.html> [accessed 27 July 2012].
[54] 1031 Exchange: Capital Gains State Tax Rates <http://www.1031x.com/capital-gains-state-tax-rate.cfm> [accessed 27 July 2012].
[55] Direct Invest- Braintree Park, LLC., Private Placement Memorandum, 13 August 2007, p. i.

a wholly owned subsidiary of Direct Invest, LLC and is managed by Direct Invest Manager, LLC. In turn, Direct Invest Property Management, LLC, a wholly owned subsidiary of Direct Invest, LLC, manages the property on a day-to-day basis. Other entities involved in the offering are: Orchard Securities, LLC which serves as Managing Broker Dealer and LBDI LLC, an affiliate of Lehman Brothers Holdings Inc., which is the Bridge Equity Provider.

Table 6 classifies the fees in three categories: fees payable at the time of the TIC interest purchase, periodic fees payable annually, and occasional fees. In this example, the upfront fees combine to 22% of the gross offering proceeds.

Table 6: Fees payable by investors in the Direct Invest – Braintree Park, LLC TIC[56]

Fee	Recipient	Units	Percentage
Upfront fees			
Selling comission	Broker dealers selling TIC interests	% of gross offering proceeds	7%
Marketing and due diligence expenses	Managing broker dealer	% of gross offering proceeds	2%
Organization and offering expenses	Sponsor	% of gross offering proceeds	2.0%
Acquisition fees and expenses	Property manager	% of gross offering proceeds	4.0%
Asset management fee	Property Manager	% of gross offering proceeds	1.4%
Bridge equity costs	Bridge Equity Provider	% of gross offering proceeds	3.8%
Loan fees and expenses	Sponsor	% of gross offering proceeds	1.8%
Periodic fees			
Property management fee	Property Manager	% annual gross revenue for the property	1.5%-2.25%
Occassional fees			
Expense reimbursement	Property Manager	% out-of-pocket costs and expenses in connection with the operation, maintenance, and repair of the property.	100%
Refinancing Fee	Property Manager	% of the amount of any loan obtained to refinance the property	1%
Construction management fee	Property Manager	% of amounts spent on construction, tenant improvements, and repairs	up to10%
Property manager loan	Property Manager	Annual rate on loans that may be provided to the TIC investors by the Property Manager to cover any deficiency of funds.	10%
Disposition fee	Property Manager	% gross sales price of the property to a third party located by the Property Manager	2%
TIC transfer fees	Property Manager	$2500 per transfer	
Leasing commissions	Property Manager	varying rates for new lease agreements	
Appearance fee	Property Manager	$2500 per appearance on unlawful detainer, tax abatement, and small claims court action appearance	

Broker dealers selling the TIC interests earn a 7% commission on their sales and the Managing Broker Dealer earns 2% of gross offering proceeds for marketing and due diligence expenses. Just like in the sale of non-traded REITs, when selling commissions

[56] Direct Invest –Braintree Park, LLC Private Placement Memorandum, August 13, 2007, pp. 66-69.

are as high as 7%, there may be a conflict of interest for the broker dealer attempting to accumulate sales commissions from a product regardless of its risks or suitability characteristics. Other upfront fees include 3.8% of the gross offering proceeds payable to the TIC Sponsor for organization and offering expenses as well as loan fees and other related expenses. The Property Manager also receives an acquisition fee and an asset management fee totaling 5.4% of gross offering proceeds. The Bridge Equity Provider receives 3.8% of gross offering proceeds.

The Property Manager collects annual fees for the management of the property totaling 1.5% to 2.25% of the annual gross revenue of the property. The Property Manager also receives 100% of its out-of-pocket costs and expenses in the operation, maintenance, and repair of the property, as well as other fees as detailed in Table 6.

The myriad of fees charged to TIC investors immediately offsets most if not all of the benefit of the capital gains tax deferral often quoted as the main advantage of investing in TIC interests. In Direct Invest – Braintree Park, LLC, upfront fees alone totaled 22% of the gross offering proceeds, which was higher than the maximum 15% in long-term federal capital gains tax at the time of the offering. The upfront fees in this case were high enough to offset the sum of federal and state capital gains tax deferral in most states. Considering the annual and occasional fees as well, the sum of fees is close to the higher capital gains taxes expected from January 2013 onwards.

C. Investors in TICs Have Few Options for Getting Out

Like non-traded REITs and private REITs, TICs are illiquid investments with minimal price transparency. Many TIC properties have a five to seven year holding period or even longer, with penalties for early exit.[57] In addition, there is no active secondary market for TIC interests.[58] Even if the TIC investor finds a prospective seller, reselling TIC interests may be a time-consuming process as the TIC investor is often required to offer his shares to existing TIC owners and the TIC sponsor before offering them to other parties. The minimal trading in TIC interests eliminates opportunities for price discovery and leaves the investor with no option than to rely on infrequent property appraisals for a measure of the fair value of his investment.

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[57] Tour-Sarkissian, Christine (2006), "Section 1031 Exchanges and Tenancy in Common Interests," *California Continuing Education of the Bar*, Vol. 29, No. 4 <http://www.tslo.com/articles/CTS_TICs-Bio.pdf> [12 January 2012].

[58] Like non-traded REITs, there do exist private secondary markets such as <www.tictrader.com> and <http://www.1031ticinvestors.com>.

D. TICs Provide Little Information on Their Financial Health.

As the fraction of vacant real estate developments increased and the prices for real estate plummeted, several TIC sponsors interrupted monthly payments to TIC investors and filed for bankruptcy. For example, DBSI Inc, an Idaho-based real estate company stopped paying dividends to investors in October 2008 and filed for Chapter 11 bankruptcy protection in November 2008.[59] DBSI was one of the country's largest TIC sponsors with roughly 240 commercial properties in over 30 states with a value of $2.4 billion co-owned by 8,500 TIC investors.[60] DBSI and its affiliates have been the subject of a number of legal actions, including a suit filed by the state of Idaho accusing DBSI of selling unregistered securities.[61] DBSI was also accused of misrepresentations regarding property loans as well as statements regarding false investment guarantees. Lastly, the suit alleged that DBSI failed to inform TIC investors that the safety of their investment hinged on DBSI making new sales.[62] In addition, a class action lawsuit was filed on behalf of TIC investors in Idaho's Fourth Judicial District Court accusing the company of making $500 million in illegal profits from fraud by reselling properties to TIC investors up to 30% above their purchase price.[63]

A suit filed by the DBSI bankruptcy trustee James Zazzali, a retired chief justice of the Supreme Court of New Jersey, alleged that:

> 'at some point in or after 2004, the DBSI enterprise took on the characteristics of a Ponzi scheme, in which the guaranteed returns of the old investors could only be satisfied by the flow of funds from the news investors.'[64]

Mr. Zazzali filed suit against 96 broker-dealers in an attempt to recover $49 million in commissions generated by the broker dealers through the sale of DBSI TIC interests. Several awards have already been granted to investors in DBSI TIC interests. A FINRA panel found that QA3 Financial Corp. "did not adequately supervise" the broker dealer selling TIC interests to an elderly couple and awarded them $1.6 million.[65]

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[59] Reuters, "DBSI, a real estate company, files for bankruptcy," 10 November 2008.
[60] Frangos, Alex, "DBSI Failure shows spread of turmoil in Real Estates" *The Wall Street Journal*, 17 November 2008.
[61] Wire, Sarah, "Idaho sues Boise-based real estate company accused of duping investors" *Associated Press*, 16 January 2009.
[62] "Idaho 'Tic' sponsor sued for securities law violations," US Fed News INDFED, 15 January 2009.
[63] Shifrin, Simon, "Idaho-based DBSI rode real estate's rise and fall," *Idaho Business Review*, November 24, 2008; Shouten, Cory, "Real estate firm in trouble," *Indianapolis Business Journal*, 10 November 2008.
[64] Kelly, Bruce, "Sour real estate deals land B-Ds in hot water," December 12, 2010, *Investment News*, <http://www.investmentnews.com/article/20101212/REG/312129971> [Accessed 30 July 2012].
[65] Kelly, Bruce, "QA3 hit with $1.6M award for sale of TICs to elderly couple," 23 January 2011, *Investment News*, < http://www.investmentnews.com/article/20110123/REG/301239982> [accessed 30 July 2012].

VI. Conclusions

Non-traded REITs and TICs are high cost, illiquid and of dubious value in a retail investors overall investment portfolio. Using pension fund examples, we argue that roughly 5% of an investor's portfolio might be allocated to additional, focused real estate investments. This additional investment should be made through low-cost open-end or closed-end mutual funds managed by individuals with the expertise and incentives to construct diversified portfolios of the best REITs and direct real estate investments.