Hearing Summary Report

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Hearing Date: 8/3/2023 Today's Date: 8/7/2023

Agency: Ohio Department of Commerce

Rule Number(s): 1301:6-3-09

If no comments at the hearing, please check the box. ☒

List organizations or individuals giving or submitting testimony before, during or after the public hearing and indicate the rule number(s) in question.

1. Gina Gombar on behalf on the Institute for Portfolio Alternatives submitted written comments prior to the hearing in response to the Public Hearing Notice

2. John Cronin on behalf of LPL Financial submitted written comment letter prior to the Hearing in response to the Public Hearing Notice

3. Anthonio Fiore of Keglar, Brown, Hill and Ritter submitted written comment letters on behalf of the Joint Trades prior to the hearing in response to the Public Hearing Notice

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Hearing Summary Report

Consolidated Summary of Comments Received

Please review all comments received and complete a consolidated summary paragraph of the comments and indicate the rule number(s).

Comments on Proposed Amendment to 1301:6-3-09

The Public Hearing was held on August 3, 2023. No person(s) in attendance provided in-person testimony.

In response to the public hearing notice, The Division received a total of three written response submissions prior to the hearing.

- On July 31, 2023, Tony Fiore of Kegler Brown submitted an email on behalf of the Joint Trades, which re-attached a copy of a letter that the Joint Trades had previously sent to the Division on February 28, 2023 during the public comment process. Mr. Fiore remarked in the email message that the Joint Trades still had unresolved concerns, but he did not specify which concerns remained unresolved outside of a desire for more Ohio-specific data. Mr. Fiore indicated it would be helpful for the Division to share quantifiable data (complaints or product concerns) that the Division of Securities is using as a basis for pursuing this rule.

- On July 31, 2023, Gina Gombar from the Institute for Portfolio Alternatives ("IPA") submitted an email on IPA's behalf, attaching a letter expressing continued concerns regarding the rule proposal and requesting the proposal be withdrawn to allow further comment and consideration. The letter articulated the following five concerns: (1) IPA believes that registration by qualification (1707.09) requirements should not be applied to registration by coordination (1707.091); (2) IPA believes the proposed rule creates unnecessary barriers to Ohio investment; (3) IPA believes the Division's business impact analysis is inadequate; (4) IPA believes the proposed waiver provision is unworkable; and (5) IPA questions the meaning of select text in the proposed rule.

- On August 2, 2023, John Cronin from LPL Financial submitted an email on LPL's behalf, attaching a letter requesting the Division open an additional public comment period and requesting a six-month implementation period.

Incorporated Comments into Rule(s)

Indicate how comments received during the hearing process were incorporated into the rule(s). If no comments were incorporated, explain why not.

Comments received during the hearing process were not incorporated into the rule as most comments received were reiterations of comments made during the public comment process, which the Division addressed in its rulemaking memo. Most of those comments centered around the Division's 10% concentration limit policy, with several stakeholders asking the Division to retract the policy or adopt a waiver or carve-out for Ohio purchasers meeting the federal definition of an accredited investor. The Division responded to these comments by incorporating a formal, self-executing waiver for all Ohio purchasers, whether accredited or not. The Division explained in its rulemaking memo why it did not adopt a waiver for accredited investors, which explanation is reincorporated here.

Another comment received from multiple stakeholders during the hearing process was a request for the Division to delay rule adoption and allow another round of public comment. It is unclear whether the Division has authority to grant extensions to the deadline imposed by JCARR for this special "policy into rule" undertaking. That said, the policies being codified into rule have been in place for decades and the only substantive thing that is new is the new self-executing waiver. The waiver does not impose any requirements or burdens on issuers or selling firms. Just the opposite, the waiver automatically eliminates a regulatory guideline – the 10% registration condition – upon successful submission of a form. All other hearing testimony is addressed in greater detail below.

A. Comments Received from Joint Trades

In its rulemaking memo and supplemental business impact analysis, the Division responded to the comments set forth in the February 28, 2023 Joint Trades letter, which they re-attached as testimony for the August 3rd hearing. The Division's summation of their comments can be found on pages 54-55 of the memo; the Division's summary response to their comments can be found on pages 61-66 of the memo; and the Division's detailed response can be found in pages 66 through 95 of the memo. Based on the request of one member, the Division also hosted an in-person stakeholder meeting on March 31, 2023 to discuss the proposal and obtain additional stakeholder feedback. Summation of the stakeholder meeting can be found on pages 56-60 of the memo.

The Division included voluminous data regarding concerning non-traded REITs and BDCs in pages 6-48 of the rulemaking memo. There are numerous charts and other references citing quantifiable data in that material with separate sections detailing product complexity, costs, fees, expenses, risks, and suitability for retail investors. Within these sections, there is a subsection (starting on page 30) that specifically discusses the impact of recent gating activity specifically in Ohio; a section (starting on page 25) that specifically discusses the impact on older and retired

investors; and a section (starting on page 40) that specifically discusses complaints, frauds, and failures of these products.

Some of the quantifiable facts provided in these sections include:

- The two largest NAV REIT sponsors that control 74% of the REIT market initiated the largest lockup in REIT history in December, freezing more than $80 billion in investor shares. Over 1 million of those shares were held by Ohio investors, locking them out of $20.5 million of their own money. The lockup continues to this day, with one sponsor having affirmatively rejected $28 billion in requests in the past nine months (updated data through July 2023). In its memo, the Division shared that Ohio investors were denied individual redemption requests exceeding $100,000 and at least Ohio business was prevented from pulling out more than $2 million of its money. Thankfully, the Division's 10% concentration limit has made sure that Ohio investors do not have more than 10% of their portfolios frozen in the lockup.

- Non-traded REITs and BDCs produce a disproportionate number of customer complaints, as illustrated in the statistical data and charts highlighted on pages 42-43 of the memo and cases and regulatory actions noted in Appendix C. Although stakeholders have suggested that these complaints are vestiges of older lifecycle REITs, the Division shared exam findings from 50 selling firms indicating that is not the case. 37% of those firms (who collectively hold almost $1 billion in NAV products) did in fact have customer complaints involving the new NAV products. The Division also shared that the complaint rate was lower for Ohio (6%) at these firms, indicating Ohio's policies are curbing investor harm and hardships experienced at a higher rate in other jurisdictions. The selling firms examined by the Division are members of the Joint Trade associations and have access to the data cited by the Division as well as access to any countervailing data, should it exist.

- Non-traded REITs are frequently marketed and sold to vulnerable investor populations, most notably older individuals investing for retirement purposes. The Division shared exam findings indicating 80% of the Ohio investors holding non-traded REITs are at or near retirement age. The Division found that 47% of the Ohio accounts were held by investors over the age of 65. The data was pulled from Joint Trade association members, from which countervailing data could have been produced if it existed.

- The Division's policies have protected Ohio investors from losing their money in large REIT failures, including the billion-dollar United Development Funding REIT fraud. The Division blocked the deal, preserving Ohio wealth. The SEC (who reports it only conducts sporadic disclosure reviews) and other states cleared it, exposing the fraud to more than 30,000 investors in other states.

- Without any formal state or federal rules codifying percentage limits, 85% of selling firms already impose concentration limits on non-traded REITs, BDCs, and

other alternative products in percentages that are equally or more restrictive than the Ohio policy.

B. Comments Received from Institute for Portfolio Alternatives

Nearly all of IPA's written testimony is a repeat of comments previously submitted during the rulemaking process. The Division's response to the repeat arguments can be found in the Division's rulemaking memo and supplemental business impact analysis. More specifically, the Division's summation of their comments can be found on pages 54-55 of the memo; the Division's summary response to their comments can be found on pages 61-66 of the memo; and the Division's detailed response can be found in pages 66 through 95 of the memo.

Although the Division will not repeat the bulk of its responses here, the Division will summarize the key points in response to each of the five sections of IPA's written testimony.

1. The Division's Statutory Authority

IPA does not believe the merit standard set forth in R.C. 1707.09 (applicable to registration by qualification) applies to R.C. 1707.091 (registration by coordination). The Ohio Securities Act provides otherwise. R.C. 1707.01(Q)(3) states: "Reference in this chapter to registration by qualification also includes registration by coordination unless the context otherwise indicates." The merit standard set forth in 1707.09 has always applied to 1707.091 to ensure there are no grossly unfair terms in Ohio-registered offerings and to prevent such offerings from being sold or disposed of in a fraudulent or deceptive manner. Over two years ago, the Division asked IPA to provide a legal opinion from Ohio-licensed counsel to support its novel reading of the two code provisions, but IPA has yet to produce. No other stakeholder has adopted this unusual argument.

In its testimony, IPA advances another novel argument, stating that that the 1707.09 merit standard cannot apply to 1707.091 because that would run counter to legislative intent, relying on the recent effort to amend the Ohio Securities Act through the 2024-2025 Budget Bill. The Governor vetoed that effort on July 3. As Governor DeWine stated in his veto message:

> This item would eliminate the Ohio Department of Commerce's (Commerce) longstanding ability to conduct an independent review of high-risk Real Estate Investment Trusts (REITs) marketed and sold in Ohio. The Division of Securities has used this authority for more than 100 years to screen out fraudulent deals to protect Ohio investors. Commerce's review of these high-risk investments protects vulnerable Ohioans. In recent years, investors nationwide have lost hundreds of millions of dollars in fraudulent products that were either denied access by Commerce or did not even attempt to market and sell in Ohio. Under this authority, Ohioans benefit from having access to a robust market of available REITs that have complied with Ohio's standards. Removing this

> authority will place Ohioans at greater risk and diminish consumer confidence in the available products on the market. Therefore, the veto of this item is in the public interest.

IPA does not explain how vetoed legislation qualifies as evidence of legislative intent. JCARR procedures speak only to the "intent of the legislature in *enacting* the statute under which the rule is proposed," and not failed attempts to amend the statute decades later. No other stakeholder has adopted this unusual argument.

2. Barriers to Ohio Investment

IPA argues that the proposed revisions should be withdrawn because they will create unnecessary barriers to investment. IPA cites no data to support this contention. To the contrary, the policies being codified are what have allowed non-traded REITs and BDCs to raise billions of dollars of capital here in Ohio. As noted in the memo, most of the capital raised recently has been taken out of Ohio to promote development in other states. Moreover, the data suggests that sponsor developments in the residential and commercial property space have had an adverse impact on many families and small businesses struggling to buy a home or make rent. As for investor choice, the Division revised its policy to give all Ohio investors – at every income level – a self-executing waiver of the 10% concentration limit. Once the key risks are duly acknowledged and the form submitted, the registration condition goes away.

3. The Division's Business Impact Analysis

IPA argues that the Division's business impact analysis is inadequate, claiming the Division provides "virtually no critical information" that would support a proper business impact analysis. The Division worked significant overtime on this rulemaking proposal, dedicating considerable energy and staff resources to draft a rule that encapsulates an unspecified set of guidelines issued over the course of the past thirty years and compile a thorough business impact analysis. This was no easy feat and, with all due respect, the Division does not believe anyone who actually reads the Division's memo can walk away without a clear understanding of the type, scope, and scale of problems that the Division is intending to address through this rulemaking. The problems with non-traded REITs and BDCs are well chronicled in the memo, as is the Division's historical success in mitigating those problems without banning the products outright.

4. Waiver Provision

IPA believes the proposed waiver provision is unworkable, arguing it will impose unwarranted costs on selling firms and reiterating its preference for an accredited investor carveout instead. Once again, the Division respectfully disagrees. There is nothing complex or unworkable about the waiver process or the waiver form. It's a simple, one-page document that an Ohio investor can fill out in under a minute and submit online or by mail for free. While the Division understands that IPA would prefer that the Division follow an alternative accredited investor waiver process, the Division's

memo explained in detail why that approach falls short of Ohio's investor protection standard. See, e.g., Impact on Older and Retired Investors; Complaints, Fraud, and Failures; and the Suitability for Retail Investors sections of the memo; the customer complaints and regulatory actions cited in Appendix C; and the discussion on page 73. Using IPA's logic, the Division should not entertain any kind of carveout or waiver– not even one for accredited investors – because selling firms would incur some expense to implement any form of carveout into their systems.

Stated concerns about accessibility, education, cost and compliance systems for selling firms are really red herrings. The 10% concentration limit is a registration condition that was implemented years ago and is already factored into selling firm policies and compliance systems. In this rule, Ohio purchasers, not selling firms, are the ones who are given the right to seek a waiver of that limit. The form is explicitly clear that selling firm obligations are governed by separate federal and state conduct standards, as has always been the case for firms selling products that are restricted by almost half the states.

5. Meaning of Text in Proposed Revisions

IPA raises questions regarding the meaning of select text contained in the proposed rule. Most of the questions involve text that was included in the initial draft of revisions, for which IPA raised no objection or comment during the public comment period.

- IPA questions what "other issuers of the same security" means. Ohio's concentration limit is not new, it has been enforced for years with consistent compliance by IPA members who fully understand this language. For an issuer of a non-traded REIT, the limit would apply to "other issuers" of non-traded REITs, the same security type.
- IPA questions whether various securities types are included when offered by an affiliate. As is clear from the language in the rule and as the memo explains, the limit "does not apply" to affiliated offerings that (i) are not subject to registration in accordance with R.C. 1707.09 or 1707.091 (i.e., federally covered securities) or (ii) do not restrict distribution or exit for a significant or indefinite period of time. Thus, the limit would not apply to index funds, money market funds, and mutual funds because they (i) are not subject to registration in accordance with R.C. 1707.09 or 1707.091 and (ii) generally do not restrict distribution or exit for a significant or indefinite period of time.
- IPA questions what it means to restrict a purchaser's distributions or ability to exit for an indefinite or significant period of time. The language means what it says and, as explained in the memo and in the March in-person meeting, it is the same language that IPA own members use to disclose the unique distribution and redemption restrictions observed with non-traded REITs and BDCs.
- IPA questions why the policy is applied to affiliates, indicating the restriction could apply to federally covered securities. This is a comment that IPA raised in response to the Division's initial draft and prompted the clarifying changes that the Division made in the final version. The proposed revisions states that the limit does not apply to securities that are "not subject to registration in accordance with R.C.

1707.09 or 1707.091," which language expressly excludes all federally covered securities as a result. See Division discussion on pages 74-76 of the memo.

- IPA asks how "liquid net worth" is defined. As is the case with FINRA and SEC rules, the term is securities vernacular and is to be understood commensurate with its meaning in financial analysis. Accordingly, the term has the same meaning that IPA members ascribe it in prospectuses and customer communications. As noted on page 75 of the rulemaking memo, issuers currently demonstrate their understanding of the term by including the following language in the product prospectus: "'liquid net worth' is defined as that portion of net worth (total assets exclusive of home, home furnishings, and automobiles minus total liabilities) that is comprised of cash, cash equivalents, and readily marketable securities." See Suitability Section of Appendix A materials.

C. Comments Received from LPL Financial

LPL Financial asked the Division to open an additional public comment period for the proposal and to give selling firms a six-month implementation period for implementing the rule. As noted above, it is unclear whether the Division has authority to extend the six-month deadline imposed by JCARR for this specialized "policy into rule" undertaking. But even if it had that authority, the Division would be reluctant to open another comment period after other stakeholders have aggressively pushed both the Division and JCARR to complete this rule. In addition, the proposed revisions are codifications of policies that were implemented by stakeholders long ago. The only new twists to these policies are that the Division has (1) clarified the concentration limit policy to emphasize that it does not apply to insurance products, federally covered securities, or offerings that do not restrict distribution or exit for a significant or extended period of time [a clarification that stakeholders requested in their comments] and (2) relaxed the concentration limit policy by providing Ohio purchasers with a self-executing waiver process and form [even more accommodating than the waiver requested in comments].

As stated in page 65 of the memo: "To the extent existing policies have been revised, they have generally been relaxed to accommodate industry concerns noted in the stakeholder feedback. The Division would be fine with those accommodations taking immediate effect in the event of JCARR approval, but stakeholders may choose to phase them in at their convenience on the schedule that works the best for them. Anti-fraud and investor protection safeguards that have been enforced for many years and are already in effect will not be suspended."