NON-TRADED REIT FRAUD 101

Chances are good that if you are reading this article, you either lost money in a REIT or have a client with such losses. The purpose of this post is to provide a basic description of REIT losses and how to secure a recovery.

First, a brief primer on REITs.

Interest rates have been quite low for the last several years. Although rates have risen slightly in the last few months, Treasury bills and certificates of deposit rates are still at near historic lows. When rates are low for extended periods, investors seek investments offering better yields. One such popular product is a REIT – short for Real Estate Investment Trust.

Investopedia defines REIT as follows:

"A security that sells like a stock on the major exchanges and invests in real estate directly, either through properties or mortgages. REITs receive special tax considerations and typically offer investors high yields, as well as a highly liquid method of investing in real estate."

REITs began in 1960 when Congress passed legislation to provide greater investment opportunities for ordinary Americans. REITs allow numerous investors to pool their resources and invest in large properties or portfolios of properties. Common investment properties found in REITs include shopping centers, office parks, cell towers, warehouses and apartment buildings. Acting alone, few investors could afford to purchase such properties.

REITs are also popular because they pay dividends and receive special tax treatment. The tax code requires REITs to distribute at least 90% of their income back to investors. Unlike ordinary companies, however, a qualified REIT can deduct distributions paid to investors thus avoiding double taxation.

It's not just investors who like REITs. Investment professionals such as stockbrokers love them because they pay commissions far above usual market rates. Discount online brokerage services have driven down commissions on ordinary stock transactions, not so for certain REITs, however, which frequently pay commissions of 7% or more.

There are two types of REITs. The first type trades on national securities exchanges just like a stock. These offer good liquidity and often pay dividends as well. While any investment offers risks, we see few complaints on these publicly traded REITs

The second type of REITs are publicly registered non-exchange traded REITs. These are the source of most investor complaints. Often called “non-traded REITs,” these investments are usually very illiquid meaning there is no ready secondary market for shares. Invest in one of these and you may be stuck holding it for a decade or more.

The Financial Industry Regulatory Authority, the SEC and several states have warned investors to be very careful before investing in a non-traded REIT. Unfortunately for investors, these are the REITs that normally pay the highest commissions to brokers and carry the highest fees.

There is a great deal of confusion with investors. Although non-traded REITs are frequently marketed as “publicly *registered*,” they are not “publicly *traded*”.

Even more risky is a third type of REIT called a private REIT. These are rare and are usually associated with private placement offerings. They can be extremely risky and can only be offered to accredited investors who meet very specific liquidity and sophistication standards. Like their publically registered, nontraded cousins, these investments are also difficult to value and sell if cash is needed

Non-traded REITs and private REITs are generally not suitable for investors who may need access to their money in the short or medium term. That means they are not generally suitable for retirees and elderly investors who need their savings to pay bills. Unfortunately we have seen many instances of brokers selling these products to elderly clients, often with disastrous results.

Since most REITs are sold by stockbrokers, getting back your money usually means arbitrating claims before the Financial Industry Regulatory Authority – FINRA. Although appeal rights are very limited, most investors and their lawyers are satisfied with the process. The general turnaround time from filing to adjudication is about 14 months. Punitive damages and meaningful attorney’s fees are rare but not impossible.

Stockbrokers have a legal obligation to know their customers. These “KYC” requirements include age, risk tolerance, liquidity and the need to access their funds in the near or medium term. Brokers also have an obligation to only recommend suitable investments. That means not recommending non-traded REITs to elderly investors.

Finally, brokers have an obligation to fully explain investments to their clients. We know from experience that many holders of non-traded REITs never knew they might have to wait a decade before hey could access their funds.

The bottom line? If you are a retiree, senior citizen or conservative investor and your stockbroker recommended you buy a private or non-traded REIT, you may be able to recover full compensation for your loss.

About the author. **Brian Mahany** is an attorney and the author of the popular Due Diligence blog. He also writes for REITlossrecovery.com